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

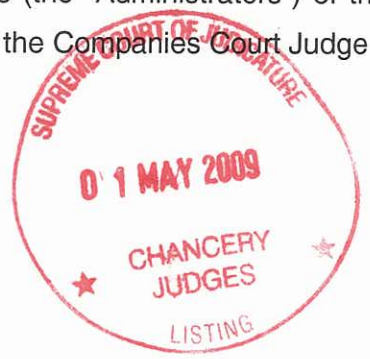
ORDINARY APPLICATION

TAKE NOTICE that Steven Anthony Pearson, Anthony Victor Lomas, Michael John Andrew Jervis and Dan Yoram Schwarzmann of PricewaterhouseCoopers LLP, Plumtree Court, London EC4A 4HT, the administrators (the "Administrators") of the above-named company (the "Company") intend to apply to the Companies Court Judge on:

Date: 15/5/09

Time: NBlo·30

Place: CT 54 T/E 2hrs



For directions pursuant to paragraph 63 of Schedule B1 and for orders as follows:

1 On the proper construction of CASS:

Identification of the client money pool

Which accounts?

1.1 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?

1.2 Do the answers to question 1.1 above change where the accounts in question are held not in LBIE's name but in the name of a nominee of LBIE?

1.3 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;

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

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

(a) the client bank accounts that LBIE maintained as at 7.56am on 15 September 2008 (the time at which the Administrators were appointed, and which is referred to herein as the "Time of Administration");

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

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

Which sums standing to the credit of one or more of those accounts?

1.5 If the answer to question 1.1(b), 1.1(c) and/or 1.1(d) above is "no", is LBIE obliged to transfer any identifiable client money held by it at the Time of Administration in an account other than a client bank account 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))?

1.6 Is money which was due to LBIE at the Time of Administration and which would, in the ordinary course, have been swept into LBIE's house accounts during the daily reconciliation scheduled for the morning of 15 September 2009 or 16 September 2009, had the administration not intervened, notionally pooled pursuant to CASS 7.9.6R or should it be excluded from the notional pooling?

1.7 If the answer to question 1.6 above is that such money should be excluded from the notional pooling:

(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 client money pool constituted on the notional pooling provided for in CASS 7.9.6R(1) (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 1.7(a) 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)?

<u>Holding of pre-administration client money</u>

1.8 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 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 Administration) and the Time of Administration?

1.9 Save as required by the answer to question 1.8 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 market movements 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 Administration) and the Time of Administration 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?

1.10 Save as required by the answers to questions 1.8 and/or 1.8 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?

1.11 Is LBIE not now required to adjust the CMP or otherwise 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 Administration which, absent administration, would otherwise have led to an upward adjustment by LBIE of the client money segregated by it?

1.12 In relation to any payments which LBIE is required to make pursuant to the answers to questions 1.8 and/or 1.8 and/or 1.9 and/or 1.11 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 LBIE obliged to make any payment:

(i) into a client bank account opened by LBIE prior to the time of administration and, if so, whether such money then becomes subject to CASS 7.9.6R(1);

(ii) 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))?

1.13 Is LBIE entitled to recalculate a client's client money entitlement by reference to, or alternatively to take into account in calculating the amount to be distributed to a particular client (i.e. by deducting from the distribution which would otherwise be payable to the client), events occurring since the Time of Administration which, absent administration, would otherwise have led to a downward adjustment by LBIE of the client money segregated by it?

1.14 If the answer to question 1.13 above is "no":

(a) Is a client money entitlement defeasible by reason of events occurring since the Time of Administration?

(b) Can delivery of a security discharge the obligation on LBIE to pay (in whole or in part) a distribution from the CMP?

Calculation of client money entitlements

1.15 Does a client for whom LBIE was required or had agreed to hold client money on a segregated basis have a client money entitlement:

(a) in relation to a position or instrument in respect of which LBIE held money on a segregated basis at the Time of Administration;

(b) in relation to a position or instrument in respect of which LBIE did not hold money on a segregated basis at the Time of Administration.

1.16 Does a client for whom LBIE was neither required nor had agreed to hold client money on a segregated basis have a client money entitlement:

(a) in relation to a position or instrument in respect of which LBIE held money on a segregated basis at the Time of Administration;

(b) in relation to a position or instrument in respect of which LBIE did not hold money on a segregated basis at the Time of Administration.

1.17 Does a client for whom LBIE should have held client money on a segregated basis but did not, and in respect of whom client money is identifiable in LBIE's non-client money accounts, have a client money entitlement in relation to a position or instrument in respect of which LBIE did not hold money on a segregated basis at the Time of Administration.

1.18 Does a client for whom LBIE should have held client money on a segregated basis but did not, and in respect of whom client money is not identifiable in LBIE's non-client money accounts, but for whom LBIE at one time held money in its client money accounts, have a client money entitlement:

(a) in relation to a position or instrument in respect of which LBIE at one time held money on a segregated basis;

(b) in relation to a position or instrument in respect of which LBIE did not at any time hold money on a segregated basis.

1.19 Does a client for whom LBIE should have held client money on a segregated basis but did not, in respect of whom no client money is identifiable in LBIE's non-client money accounts and for whom LBIE at no time held money in its client money accounts, have a client money entitlement?

1.20 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?

1.21 Is LBIE obliged to calculate client money entitlements as at the Time of Administration, and, if not, at what time should client money entitlements be calculated?

1.22 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 Administration?

1.23 How should the client money entitlement be calculated, and, in particular:

(a) 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 Administration and/or subsequently transferred to the CMP as required by the answers to the questions above?

(b) Should a client's 'individual client balance', as referred to in CASS 7.9.7R, be calculated in accordance with paragraphs 7 and 8 of Annex 1 to CASS 7, and, if not, how should it be calculated?

Distribution of CM

1.24 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?

1.25 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 1.22 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.

Money held on behalf of affiliates

1.26 Is LBIE obliged under CASS 7 to treat money held for an affiliated company as money held in the course of or in connection with its MiFID business?

1.27 If the answer to question 1.26 is "yes", is LBIE now entitled to rely on the exemption in CASS 7.2.3R in respect of the money that LBIE should have credited (but did not) to an account falling within the description in question 1.1(a) relation to an affiliated company's positive equity balance with LBIE?

2 The Administrators' costs, fees and expenses of and occasioned by this application be paid:

(a) as an expense of the administration; or

(b) from client money subject of the statutory trust; or

(c) in part as an expense of the administration and in part from client money subject of the statutory trust;

in such proportions as shall be ordered by the Court, and/or that such other order may be made as to the incidence of the Administrators' costs, fees and expenses of this application as the Court thinks fit.

3 That representative respondents be appointed for the purpose of this application pursuant to CPR 19.6, and that provision be made for their costs.

4 Such further order or relief as the Court thinks fit.

Dated this 1 day of May 2009

EILAN CLARKE, PARTNER LINKLATERS LLP.

Linklaters LLP

Solicitors for the Applicant

Address for service: Linklaters LLP, One Silk Street, London, EC2Y 8HQ, Ref: Satindar Dogra/Harriet Ellis

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ORDINARY APPLICATION

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Solicitors for the Applicants

Applicants
S A Pearson
Third Statement
"SAP3"
1 May 2009

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EXHIBIT "SAP3"

This is the paginated bundle of copy documents marked "SAP3" referred to in the witness statement of STEVEN ANTHONY PEARSON dated 1st day of May 2009.

Signed:.....

STEVEN ANTHONY PEARSON

1 May 2009

Index to SAP3

Lehman companies currently in administration are as follows:

1. Lehman Brothers Holdings Plc

Company Number :	**01854685**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis and Dan Yoram Schwarzmann
In Administration From :	15 September 2008
Matter Number :	**L-159771**

2. Lehman Brothers International (Europe)

Company Number :	**02538254**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis and Dan Yoram Schwarzmann
In Administration From :	15 September 2008
Matter Number :	**L-159763**

3. Lehman Brothers Limited

Company Number:	**00846922**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis and Dan Yoram Schwarzmann
In Administration From :	15 September 2008
Matter Number :	**L-159770**

4. LB UK RE Holdings Limited

Company Number :	**05347966**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis, Dan Yoram Schwarzmann and Graham Hunter Martin (Graham Hunter Martin was appointed on the 29th October 2008)
In Administration From :	15 September 2008
Matter Number :	**L-159764**

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5. Storm Funding Limited

Company Number :	**02682306**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis and Dan Yoram Schwarzmann
In Administration From :	23 September 2008
Matter Number :	**L-159982**

6. Mable Commercial Funding Limited

Company Number :	**02682316**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis, Dan Yoram Schwarzmann and Graham Hunter Martin (Graham Hunter Martin was appointed on the 29th October 2008)
In Administration From :	23 September 2008
Matter Number :	**L-159981**

7. Lehman Brothers Europe Limited

Company Number :	**03950078**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis and Dan Yoram Schwarzmann
In Administration From :	23 September 2008
Matter Number :	**L-160034**

8. Lehman Brothers UK Holdings Limited

Company Number :	**02074637**
Administrators :	Anthony Victor Lomas, Michael John Andrew Jervis and Derek Anthony Howell
In Administration From :	29 September 2008
Matter Number :	**L-160270**

9. LB SF No.1

Company Number:	**06001928**
Administrators:	Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann

In Administration From : 2 October 2008

Matter Number : **L-160440**

10. LB UK Financing Ltd

Company Number: **05729776**

Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann

In Administration From : 2 October 2008

Matter Number : **L-160442**

11. Cherry Tree Mortgages Limited

Company Number: **05529374**

Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann

In Administration From: 13 October 2008

Matter Number: **L-160728**

12. Lehman Brothers Lease and Finance No.1 Limited

Company Number: **04387086**

Administrators: Anthony Victor Lomas, Derek Anthony Howell and Michael John Andrew Jervis

In Administration From: 24 October 2008

Matter Number: **L-161287**

13. Zestdew Limited

Company Number: **03752197**

Administrators: Anthony Victor Lomas, Derek Anthony Howell, Dan Yoram Schwarzmann and Graham Hunter Martin.

In Administration From: 29 October 2008

Matter Number: **L-161381**

14. Monaco NPL (No. 1) Limited

Company Number: **05432398**

Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann

In Administration From: 29 October 2008

Matter Number: **L-161418**

15. Lehman Commercial Mortgage Conduit Limited

Company Number: **06221756**

Administrators: Anthony Victor Lomas, Derek Anthony Howell, Dan Yoram Schwarzmann and Graham Hunter Martin

In Administration From: 30 October 2008

Matter Number: **L-161442**

16. LB RE Financing No.3 Limited

Company Number: **06454161**

Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann

In Administration From: 30 October 2008

Matter Number: **L-161419**

17. Lehman Brothers (PTG) Limited

Company Number: **04108157**

Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann

In Administration From: 6 November 2008

Matter Number: **L-161711**

18. Eldon Street Holdings Limited

Company Number: **04108165**

Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann

In Administration From: 9 December 2008

Matter Number: **L-162936**

19. LB Holdings Intermediate 2 Limited

Company Number: **05957878**

Administrators: Anthony Victor Lomas, Steven Anthony Pearson, Derek Anthony Howell and Michael John Andrew Jervis

In Administration From: 14 January 2009

Matter Number: **L-163759**

Chapter 7

Client money: MiFID business

7.1 Application and Purpose

Application

7.1.1 R This chapter (the *client money rules*) applies to :

(1) a *MiFID investment firm*:

(a) that holds *client money*; or

(b) that opts to comply with this chapter in accordance with ■ CASS 7.1.3 R (1) (Opt-in to the MiFID client money rules); and

(2) a *third country investment firm* that opts to comply with this chapter in accordance with ■ CASS 7.1.3 R (2) (Opt-in to the MiFID client money rules);

unless otherwise specified in this section.

7.1.2 G ■ CASS 7.2 (Definition of client money) sets out the circumstances in which *money* is considered *client money* for the purposes of this chapter.

Opt-in to the MiFID client money rules

7.1.3 R (1) A *firm* that receives or holds *money* in respect of which this chapter applies and *money* in respect of which the *non-directive client money chapter* or the *insurance client money chapter* applies, may elect to comply with the provisions of this chapter in respect of all such *money* and if it does so, this chapter applies as if all such *money* were *money* that the *firm* receives and holds in the course of, or in connection with, its *MiFID business*.

(1A) A *third country investment firm* that receives or holds *money* from, for or on behalf of a *client* in the course of, or in connection with, its *equivalent business of a third country investment firm* may elect to comply with the provisions of this chapter in respect of the *money* it holds to which the *non-directive client money chapter* or the *insurance client money chapter* applies. If it does so, this chapter applies as if

all such *money* were *money* that the *firm* receives and holds in the course of, or in connection with, *MiFID business*.

(2) A *firm* must make and retain a written record of any election it makes under this *rule*, including the date from which the election is to be effective. The *firm* must make the record on the date it makes the election and must keep it for a period of five years after ceasing to use it.

7.1.4 G The opt-in to the *client money rules* in this chapter does not apply in respect of *money* that a *firm* holds outside of the scope of the *non-directive client money chapter* or the *insurance client money chapter* , such as *money* falling within the scope of the opt-out for *non-IMD designated investment business* (see ■ CASS 4.1.11 R).

7.1.5 G If a *firm* has opted to comply with this chapter, the *non-directive client money chapter* or the *insurance client money chapter* will have no application to the activities to which the election applies.

7.1.6 G A *firm* (other than a *third country investment firm*) that is only subject to the *non-directive client money chapter* or the *insurance client money chapter* may not opt to comply with this chapter.

7.1.7 G If a *firm* that has agreed with an *insurance undertaking* under the *client money rules* in the *insurance client money chapter* to treat the undertaking's *money* as *client money*, opts in to this chapter in accordance with this section, the *insurance undertaking's* interest under the trust (or in Scotland agency) will be subordinated to the interests of the *firm's* other *clients*.

7.1.7A G The information requirements concerning the safeguarding of *client money* (see ■ COBS 6.1.7 R) apply to a *firm* that has elected to comply with this chapter with respect of all *client money* to which the election applies.

Credit institutions

7.1.8 R The *client money rules* do not apply to a *BCD credit institution* in relation to deposits within the meaning of the *BCD* held by that *institution*.

[Note: article 13(8) of *MiFID* and article 18(1) of the *MiFID implementing Directive*]

7.1.9 G If a *credit institution* that holds *money* as a deposit with itself is subject to the *requirement to disclose information before providing services*, it should, in compliance with that obligation, notify the *client* that:

(1) *money* held for that *client* in an account with the *credit institution* will be held by the *firm* as banker and not as trustee (or in Scotland as agent); and

(2) as a result, the *money* will not be held in accordance with the *client money rules*.

7.1.10 G Pursuant to *Principle* 10 (Clients' assets), a *credit institution* that holds *money* as a deposit with itself should be able to account to all of its *clients* for amounts held on their behalf at all times. A bank account opened with the *firm* that is in the name of the *client* would generally be sufficient. When *money* from *clients* deposited with the *firm* is held in a pooled account, this account should be clearly identified as an account for *clients*. The *firm* should also be able to demonstrate that an amount owed to a specific *client* that is held within the pool can be reconciled with a record showing that individual's *client* balance and is, therefore, identifiable at any time. Similarly, where that *money* is reflected only in a *firm's* bank account with other banks (nostro accounts), the *firm* should be able to reconcile amounts owed to that *client* within a reasonable period of time.

7.1.11 G A *credit institution* is reminded that the exemption for deposits is not an absolute exemption from the *client money rules*.

Affiliated companies

7.1.12 G A *firm* that holds *money* on behalf of, or receives *money* from, an *affiliated company* in respect of *MiFID business* must treat the *affiliated company* as any other *client* of the *firm* for the purposes of this chapter.

7.1.13 G A *firm* that holds *client money* on behalf of, or receives *money* from, an *affiliated company* in respect of its *non-MiFID business* and opts under ■ CASS 7.1.3 R (1) to comply with this chapter in with respect of that *non-MiFID business*, should refer to the *non-directive client money chapter* (see ■ CASS 4.1.18 R (Affiliated companies)) to determine whether that money falls within the scope of the non-directive client money chapter and therefore within the scope of the opt-in.

Coins

7.1.14 R The *client money rules* do not apply with respect to coins held on behalf of a *client* if the *firm* and the *client* have agreed that the *money* (or *money* of that type) is to be held by the *firm* for the intrinsic value of the metal which constitutes the coin.

Solicitors

7.1.15 R (1) An *authorised professional firm* regulated by the Law Society (of England and Wales), the Law Society of Scotland or the Law Society of Northern Ireland must comply with the *MiFID client money (minimum implementing) rules* and also with the following rules of its *designated professional body* and if it does so, it will be deemed to comply with the *client money rules* in this chapter.

(2) The relevant rules are:

(a) if the *firm* is regulated by the Law Society (of England and Wales):

(i) the Solicitors' Accounts Rules 1998; or

(ii) where applicable, the Solicitors Overseas Practice Rules 1990;

(b) if the *firm* is regulated by the Law Society of Scotland, the Solicitors' (Scotland) Accounts, Accounts Certificate, Professional Practice and Guarantee Fund Rules 2001; and

(c) if the *firm* is regulated by the Law Society of Northern Ireland, the Solicitors' Accounts Regulations 1998.

General purpose

7.1.16 G

(1) *Principle* 10 (Clients' assets) requires a *firm* to arrange adequate protection for *clients'* assets when 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*.

7.2 Definition of client money

7.2.1 R For the purposes of this chapter and the *MiFID custody chapter*, *client money* means any *money* that a *firm* receives from or holds for, or on behalf of, a *client* in the course of, or in connection with, its *MiFID business* unless otherwise specified in this section.

Business in the name of the firm

7.2.2 R *Money* is not *client money* where the *firm* carries on business in its own name on behalf of the *client* where that is required by the very nature of the transaction and the *client* is in agreement.

[Note: recital 26 to *MiFID*]

Title transfer collateral arrangements

7.2.3 R 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*.

[Note: recital 27 to *MiFID*]

7.2.4 G A title transfer financial collateral arrangement under the *Financial Collateral Directive* is an example of a type of transfer of *money* to cover obligations where that *money* will not be regarded as *client money*.

7.2.5 G Where a *firm* has received full title or full ownership to *money* under a collateral arrangement, the fact that it has also taken a security interest over its obligation to repay that *money* to the *client* would not result in the *money* being *client money*. This can be compared to a situation in which a *firm* takes a charge or other security interest over *money* held in a *client bank account*, where that *money* would still be *client money* as there would be no absolute transfer of title to the *firm*. However, if that security interest includes a "right to use arrangement", under which the *client* agrees to transfer all of its rights to *money* in that account to the *firm* upon the exercise of the right to use, the *money* may cease to be *client money*, but only once the right to use is exercised and the *money* is transferred out of the account to the *firm*.

7.2.6 G *Firms* are reminded of the *client's best interest rule*, which requires a *firm* to act honestly, fairly and professionally in accordance with the best interests of its *clients*

when structuring its business particularly in respect of the effect of that structure on *firms'* obligations under the *client money rules*.

7.2.7 G Pursuant to the *client's best interests rule*, a *firm* should ensure that where a *retail client* transfers full ownership of *money* to a *firm*:

(1) the *client* is notified that full ownership of the *money* has been transferred to the *firm* and, as such, the *client* no longer has a proprietary claim over this *money* and the *firm* can deal with it on its own right;

(2) the transfer is for the purposes of securing or covering the *client's* obligations;

(3) an equivalent transfer is made back to the *client* if the provision of collateral by the *client* is no longer necessary; and

(4) there is a reasonable link between the timing and the amount of the collateral transfer and the obligation that the *client* owes, or is likely to owe, to the *firm*.

Money in connection with a "delivery versus payment" transaction

7.2.8 R *Money* need not be treated as *client money* in respect of a delivery versus payment transaction through a commercial settlement system if it is intended that either:

(1) in respect of a *client's* purchase, *money* from a *client* will be due to the *firm* within one *business day* upon the fulfilment of a delivery obligation; or

(2) in respect of a *client's* sale, *money* is due to the *client* within one *business day* following the *client's* fulfilment of a delivery obligation;

unless the delivery or payment by the *firm* does not occur by the close of business on the third *business day* following the date of payment or delivery of the *investments* by the *client*.

Money due and payable to the firm

7.2.9 R (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*.

7.2.10 G *Money* held as *client money* becomes due and payable to the *firm* or for the *firm's* own account, for example, because the *firm* acted as *principal* in the contract or the *firm*, acting as agent, has itself paid for *securities* in advance of receiving the purchase *money* from its *client*. The circumstances in which it is due and payable will depend on the contractual arrangement between the *firm* and the *client*.

7.2.11 G When a *client's* obligation or liability, that is secured by that *client's* asset, crystallises, and the *firm* realises the asset in accordance with an agreement entered into between the *client* and the *firm*, the part of the proceeds of the asset to cover such liability that is due and payable to the *firm* is not *client* money. However, any proceeds of sale in excess of the amount owed by the *client* to the *firm* should be paid over to the *client* immediately or be held in accordance with the *client money rules*.

Commission rebate

7.2.12 G When a *firm* has entered into an arrangement under which *commission* is rebated to a *client*, those rebates need not be treated as *client money* until they become due and payable to the *client* in accordance with the terms of the contractual arrangements between the parties.

7.2.13 G When *commission* rebate becomes due and payable to the *client*, the *firm* should:

(1) treat it as *client money*; 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);

unless the *firm* and the *client* have entered into an arrangement under which the *client* has agreed to transfer full ownership of this *money* to the *firm* as collateral against payment of future professional fees (see ■ CASS 7.2.3 R (Title transfer collateral arrangements)).

Interest

7.2.14 R Unless a *firm* notifies a *retail client* in writing whether or not interest is to be paid on *client money* and, if so, on what terms and at what frequency, it must pay that *client* all interest earned on that *client money*. Any interest due to a *client* will be *client money*.

Discharge of fiduciary duty

7.2.15 R *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*, unless it is transferred to a third party in the course of effecting a transaction, in accordance with ■ CASS 7.5.2 R (Transfer of client money to a third party); or

(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 ■ CASS 7.2.9 R (Money due and payable to the firm)); or

(5) to the *firm* itself, when it is an excess in the *client bank account* (see ■ CASS 7.6.13 R (2) (Reconciliation discrepancies)).

7.2.16 G When a *firm* wishes to transfer *client money* balances to a third party in the course of transferring its business to another *firm*, it should do so in a way which it discharges its fiduciary duty to the *client* under this section.

7.2.17 R **When a *firm* draws a cheque or other payable order to discharge its fiduciary duty 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.**

Allocated but unclaimed client money

7.2.18 G The purpose of the *rule* on allocated but unclaimed *client money* is to allow a *firm*, in the normal course of its business, to cease to treat as *client money* any balances, allocated to an individual *client*, when those balances remain unclaimed.

7.2.19 R **A *firm* may cease to treat as *client money* any unclaimed *client money* balance if it can demonstrate that it has taken reasonable steps to trace the *client* concerned and to return the balance.**

7.2.20 E (1) Reasonable steps should include:

(a) entering into a written agreement, in which the *client* consents to the *firm* releasing, after the period of time specified in (b), any *client money* balances, for or on behalf of that *client*, from *client bank accounts*;

(b) determining that there has been no movement on the *client's* balance for a period of at least six years (notwithstanding any payments or receipts of charges, interest or similar items);

(c) writing to the *client* at the last known address informing the *client* of the *firm's* intention of no longer treating that balance as *client money*, giving the *client* 28 days to make a claim;

(d) making and retaining records of all balances released from *client bank accounts*; and

(e) undertaking to make good any valid claim against any released balances.

(2) Compliance with (1) may be relied on as tending to establish compliance with ■ CASS 7.2.19 R.

(3) Contravention of (1) may be relied on as tending to establish contravention of ■ CASS 7.2.19 R.

7.2.21 G When a *firm* gives an undertaking to make good any valid claim against released balances, it should make arrangements authorised by the *firm's* relevant *controllers* that are legally enforceable by any *person* with a valid claim to such *money*.

7.3 Organisational requirements: client money

Requirement to protect client money

7.3.1 R 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*]

7.4 Segregation of client money

Depositing client money

7.4.1 R 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;

(4) a *qualifying money market fund*.

[Note: article 18(1) of the *MiFID implementing Directive*]

7.4.2 G An account with a central bank, a *BCD credit institution* or a bank authorised in a third country in which *client money* is placed is a *client bank account*.

Qualifying money market funds

7.4.3 G Where a *firm* deposits *client money* with a *qualifying money market fund*, the units in that fund should be held in accordance with the *MiFID custody chapter*.

[Note: recital 23 to the *MiFID implementing Directive*]

7.4.4 G A *firm* that places *client money* in a *qualifying money market fund* should ensure that it has the *permissions* required to invest in and hold units in that fund and must comply with the *rules* that are relevant for those activities.

7.4.5 R A *firm* must give a *client* the right to oppose the placement of his *money* in a *qualifying money market fund*.

[Note: article 18(3) of the *MiFID implementing Directive*]

7.4.6 G If a *firm* that intends to place *client money* in a *qualifying money market fund* is subject to the *requirement to disclose information before providing services*, it should, in compliance with that obligation, notify the *client* that:

(1) *money* held for that *client* will be held in a *qualifying money market fund*; and

(2) as a result, the *money* will not be held in accordance with the *client money rules* but in accordance with the *custody rules*.

A firm's selection of a credit institution, bank or money market fund

7.4.7 R A *firm* that 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 and the arrangements for the holding of this *money*.

[Note: article 18(3) of the *MiFID implementing Directive*]

7.4.8 R When a *firm* makes the selection, appointment and conducts the periodic review of a *credit institution*, a bank or a *qualifying money market fund*, it must take into account:

(1) the expertise and market reputation of the third party; and

(2) any legal requirements or market practices related to the holding of *client money* that could adversely affect *clients*' rights.

[Note: article 18(3) of the *MiFID implementing Directive*]

7.4.9 G In discharging its obligations when selecting, appointing and reviewing the appointment of a *credit institution*, a bank or a *qualifying money market fund*, a *firm* should also consider, together with any other relevant matters:

(1) the need for diversification of risks;

(2) the capital of the *credit institution* or bank;

(3) the amount of *client money* placed, as a proportion of the *credit institution* or bank's capital and *deposits*, and, in the case of a *qualifying money market fund*, compared to any limit the fund may place on the volume of redemptions in any period;

(4) the credit rating of the *credit institution* or bank; and

(5) to the extent that the information is available, the level of risk in the investment and loan activities undertaken by the *credit institution* or bank and *affiliated companies*.

7.4.10 R A *firm* must make a record of the grounds upon which it satisfies itself as to the appropriateness of its selection of a *credit institution*, a bank or a *qualifying money market fund*. The *firm* must make the record on the date it makes the selection and must keep it from the date of such selection until five years after the *firm* ceases to use the third party to hold *client money*.

Client bank accounts

7.4.11 R A *firm* must take the necessary steps to ensure that *client money* deposited, in accordance with ■ CASS 7.4.1 R, in a central bank, a *credit institution*, a bank authorised in a third country or a *qualifying money market fund* is held in an account or accounts identified separately from any accounts used to hold *money* belonging to the *firm*.

[Note: article 16(1)(e) of the *MiFID implementing Directive*]

7.4.12 G 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 ■ CASS 7.9.3 G).

7.4.13 G A *designated client fund account* may be used for a *client* only where that *client* has consented to the use of that account and all other *designated client fund accounts* which may be pooled with it. For example, a *client* who consents to the use of bank A and bank B should have his *money* held in a different *designated client fund account* at bank B from a *client* who has consented to the use of banks B and C.

Payment of client money into a client bank account

7.4.14 G Two approaches that a *firm* can adopt in discharging its obligations under the *MiFID client money segregation requirements* are:

(1) the 'normal approach'; or

(2) the 'alternative approach'.

7.4.15 R 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.

7.4.16 G 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* comply with its obligations to perform reconciliations of records and accounts (see ■ CASS 7.6.2 R). A *firm* that adopts the alternative approach will segregate *client money* into a *client bank account* 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*.

7.4.17 G 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).

7.4.18 G 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 4.1.1 R 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).

7.4.19 G 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).

7.4.20 G Pursuant to the *MiFID client money segregation requirements*, a *firm* should ensure that any *money* other than *client money* deposited in a *client bank account* is promptly paid out of that account unless it is a minimum sum required to open the account, or to keep it open.

7.4.21 R **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.**

Automated transfers

7.4.22 G Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach that receives *client money* in the form of an automated transfer should take reasonable steps to ensure that:

(1) the *money* is received directly into a *client bank account*; and

(2) if *money* is received directly into the *firm's* own account, the *money* is transferred into a *client bank account* promptly, and in any event, no later than the next *business day* after receipt.

Mixed remittance

7.4.23 G Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach that receives a *mixed remittance* (that is part *client money* and part other *money*) should:

(1) pay the full sum into a *client bank account* promptly, and in any event, no later than the next *business day* after receipt; and

(2) pay the *money* that is not *client money* out of the *client bank account* promptly, and in any event, no later than one *business day* of the day on which the *firm* would normally expect the remittance to be cleared.

Appointed representatives, tied agents, field representatives and other agents

7.4.24 G (1) Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach should establish and maintain procedures to ensure that *client money* received by its *appointed representatives*, *tied agents*, *field representatives* or other agents is:

(a) paid into a *client bank account* of the *firm* promptly, and in any event, no later than the next *business day* after receipt; or

(b) forwarded to the *firm*, or in the case of a *field representative* forwarded to a specified business address of the *firm*, so as to ensure that the *money* arrives at the specified business address promptly, and in any event, no later than the close of the third *business day*.

(2) For the purposes of 1(b), *client money* received on *business day* one should be forwarded to the *firm* or specified business address of the *firm* promptly, and in any event, no later than the next *business day* after receipt (*business day* two) in order for it to reach that *firm* or specified business address by the close of the third *business day*. Procedures requiring the *client money* in the form of a cheque to be sent to the *firm* or the specified business address of the *firm* by first class post promptly, and in any event, no later than the next *business day* after receipt, would be in line with 1(b).

7.4.25 G The *firm* should ensure that its *appointed representatives*, *tied agents*, *field representatives* or other agents keep *client money* separately identifiable from any other *money* (including that of the *firm*) until the *client money* is paid into a *client bank account* or sent to the *firm*.

7.4.26 G A *firm* that operates a number of small branches, but holds or accounts for all *client money* centrally, may treat those small branches in the same way as *appointed representatives* and *tied agents*.

Client entitlements

7.4.27 G Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach that receives outside the *United Kingdom* a *client* entitlement on behalf of a *client* should pay any part of it which is *client money*:

(1) to, or in accordance with, the instructions of the *client* concerned; or

(2) into a *client bank account* promptly, and in any event, no later than five *business days* after the *firm* is notified of its receipt.

7.4.28 G Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach should allocate a *client* entitlement that is *client money* to the individual *client* promptly and, in any case, no later than ten *business days* after notification of receipt.

Money due to a client from a firm

7.4.29 G Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach that is liable to pay *money* to a *client* should promptly, and in any event no later than one *business day* after the *money* is due and payable, pay the *money*:

(1) to, or to the order of, the *client*; or

(2) into a *client bank account*.

Segregation in different currency

7.4.30 R **A *firm* may segregate *client money* in a different currency from that of receipt. If it does so, the *firm* must ensure that the amount held is adjusted each *day* to an amount at least equal to the original currency amount (or the currency in which the *firm* has its liability to its *clients*, if different), translated at the previous day's closing spot exchange rate.**

7.4.31 G The *rule* on segregation of *client money* in a different currency (■ CASS 7.4.30 R) does not apply where the *client* has instructed the *firm* to convert the *money* into and hold it in a different currency.

Commodity Futures Trading Commission Part 30 exemption order

7.4.32 G United States (US) legislation restricts the ability of non-US firms to trade on behalf of US customers on non-US futures and options exchanges. The relevant US regulator (the *CFTC*) operates an exemption system for *firms* authorised by the *FSA*. The *FSA* sponsors the application from a *firm* for exemption from Part 30 of the General Regulations under the US Commodity Exchange Act in line with this system. The application forms and associated information can be found on the *FSA* website in the "Forms" section.

7.4.33 G A *firm* with a *Part 30 exemption order* undertakes to the *CFTC* that it will refuse to allow any US customer to opt not to have his *money* treated as *client money* if it is held or received in respect of transactions on non-US exchanges, unless that US customer is an "eligible contract participant" as defined in section 1a(12) of the Commodity Exchange Act, 7 U.S.C. The *MiFID client money chapter* does not have the option of allowing the *firm* or the *client* to choose whether *money* belonging to the *client* is subject to the *client money rules*.

7.4.34 R **A *firm* must not reduce the amount of, or cancel a letter of credit issued under, an LME bond arrangement where this will cause the *firm* to be in breach of its *Part 30 exemption order*.**

7.4.35 R A *firm* must notify the *FSA* immediately it arranges the *issue* of an individual letter of *credit* under an LME bond arrangement.

7.5 Transfer of client money to a third party

7.5.1 G This section sets out the requirements a *firm* must comply with when it transfers *client money* to another *person* without discharging its fiduciary duty owed to that *client*. Such circumstances arise when, for example, a *firm* passes *client money* to a *clearing house* in the form of margin for the *firm's* obligations to the *clearing house* that are referable to transactions undertaken by the *firm* for the relevant clients. They may also arise when a *firm* passes *client money* to an *intermediate broker* for *contingent liability investments* in the form of initial or variation margin on behalf of a *client*. In these circumstances, the *firm* remains responsible for that *client's equity balance* held at the *intermediate broker* until the contract is terminated and all of that *client's* positions at that *broker* closed. If a *firm* wishes to discharge itself from its fiduciary duty, it should do so in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (■ CASS 7.2.15 R).

7.5.2 R A *firm* may allow another *person*, such as an exchange, a *clearing house* or an *intermediate broker*, to hold or control *client money*, but only if:

(1) the *firm* transfers the *client money*:

(a) for the purpose of a transaction for a *client* through or with that *person*; or

(b) to meet a *client's* obligation to provide collateral for a transaction (for example, an *initial margin* requirement for a *contingent liability investment*); and

(2) in the case of a *retail client*, that *client* has been notified that the *client money* may be transferred to the other *person*.

7.5.3 G A *firm* should not hold excess *client money* in its *client transaction accounts* with *intermediate brokers*, *settlement agents* and OTC counterparties; it should be held in a *client bank account*.

7.6 Records, accounts and reconciliations

Records and accounts

7.6.1 R A *firm* must keep such records and accounts as are necessary to enable it, at any time and without delay, to distinguish *client money* held for one *client* from *client money* held for any other *client*, and from its own *money*.

[Note: article 16(1)(a) of the *MiFID implementing Directive*]

7.6.2 R A *firm* must maintain its records and accounts in a way that ensures their accuracy, and in particular their correspondence to the *client money* held for *clients*.

[Note: article 16(1)(b) of the *MiFID implementing Directive*]

Client entitlements

7.6.3 G Pursuant to ■ CASS 7.6.2 R, ■ SYSC 4.1.1 R and ■ SYSC 6.1.1 R, a *firm* should take reasonable steps to ensure that is notified promptly of any receipt of *client money* in the form of a *client* entitlement.

Record keeping

7.6.4 R A *firm* must ensure that records made under ■ CASS 7.6.1 R and ■ CASS 7.6.2 R are retained for a period of five years after they were made.

7.6.5 G A *firm* should ensure that it makes proper records, sufficient to show and explain the *firm's* transactions and commitments in respect of its *client money*.

Internal reconciliations of client money balances

7.6.6 G (1) ■ SYSC 4.1.1 R requires *firms* to have robust governance arrangements, such as internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems. In addition, ■ SYSC 6.1.1 R requires *firms* to establish, implement and maintain adequate policies and procedures sufficient to ensure the *firm's* compliance with its obligations under the *regulatory system*. Carrying out internal reconciliations 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 accounts* and *client transaction*

accounts should be one of the steps a *firm* takes to satisfy its obligations under ■ CASS 7.6.2 R, ■ SYSC 4.1.1 R and ■ SYSC 6.1.1 R.

(2) A *firm* should perform such internal reconciliations:

(a) as often as is necessary; and

(b) as soon as reasonably practicable after the date to which the reconciliation relates;

to ensure the accuracy of the *firm's* records and accounts.

(3) The *standard method of internal client money reconciliation* sets out 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*.

Records

7.6.7 R (1) A *firm* must make records, sufficient to show and explain the method of internal reconciliation of *client money* balances under ■ CASS 7.6.2 R used, and if different from the *standard method of internal client money reconciliation*, to show and explain that:

(a) the method of internal reconciliation of *client money* balances used affords an equivalent degree of protection to the *firm's clients* to that afforded by the *standard method of internal client money reconciliation*; and

(b) in the event of a *primary pooling event* or a *secondary pooling event*, the method used is adequate to enable the *firm* to comply with the *client money (MiFID business) distribution rules*.

(2) A *firm* must make these records on the date it starts using a method of internal reconciliation of *client money* balances and must keep it made for a period of five years after ceasing to use it.

7.6.8 R A *firm* that does not use the *standard method of internal client money reconciliation* 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 use another method effectively.

Reconciliations with external records

7.6.9 R A *firm* must conduct, on a regular basis, reconciliations between its internal accounts and records and those of any third parties by whom *client money* is held.

[Note: article 16(1)(c) of the *MiFID implementing Directive*]

Frequency of external reconciliations

7.6.10 G (1) A *firm* should perform the required reconciliation of *client money* balances with external records:

(a) as regularly as is necessary; and

(b) as soon as reasonably practicable after the date to which the reconciliation relates;

to ensure the accuracy of its internal accounts and records against those of third parties by whom *client money* is held.

(2) In determining whether the frequency is adequate, the *firm* should consider the risks which the business is exposed, such as the nature, volume and complexity of the business, and where and with whom the *client money* is held.

Method of external reconciliations

7.6.11 G A method of reconciliation of *client money* balances with external records that the *FSA* believes is adequate is when a *firm* compares:

(1) the balance on each *client bank account* as recorded by the *firm* with the balance on that account as set out on the statement or other form of confirmation issued by the bank with which those accounts are held; and

(2) the balance, currency by currency, on each *client transaction account* as recorded by the *firm*, with the balance on that account as set out in the statement or other form of confirmation issued by the *person* with whom the account is held;

and identifies any discrepancies between them.

7.6.12 R Any *approved collateral* held in accordance with the *client money rules* must be included within this reconciliation.

Reconciliation discrepancies

7.6.13 R When any discrepancy arises as a result of a *firm's* internal reconciliations, the *firm* must identify the reason for the discrepancy and ensure that:

(1) any *shortfall* is paid into a *client bank account* by the close of business on the day that the reconciliation is performed; or

(2) any excess is withdrawn within the same time period (but see ■ CASS 7.4.20 G and ■ CASS 7.4.21 R).

7.6.14 R When any discrepancy arises as a result of the reconciliation between a *firm's* internal records and those of third parties that hold *client money*, the *firm* must identify the reason for the discrepancy and correct it as soon as possible, unless the discrepancy arises solely as a result of timing differences between the accounting systems of the party providing the statement or confirmation and that of the *firm*.

7.6.15 R While a *firm* is unable to resolve a difference arising from a reconciliation between a *firm's* internal records and those of third parties that hold *client*

money, and one record or a set of records examined by the *firm* during its reconciliation indicates that there is a need to have a greater amount of *client money* or *approved collateral* than is in fact the case, the *firm* must assume, until the matter is finally resolved, that the record or set of records is accurate and pay its own *money* into a relevant account.

Notification requirements

7.6.16 R A *firm* must inform the *FSA* in writing without delay:

(1) if it has not complied with, or is unable, in any material respect, to comply with the requirements in ■ CASS 7.6.1 R, ■ CASS 7.6.2 R or ■ CASS 7.6.9 R;

(2) if having carried out a reconciliation it has not complied with, or is unable, in any material respect, to comply with ■ CASS 7.6.13 R to ■ CASS 7.6.15 R.

Audit of compliance with the MiFID client money rules

7.6.17 G *Firms* are reminded that the auditor of the *firm* has to confirm in the report submitted to the *FSA* under ■ SUP 3.10 (Duties of auditors: notification and report on client assets) that the *firm* has maintained systems adequate to enable it to comply with the *client money rules*.

7.6.18 G *Firms* that do not adopt the normal approach are reminded that the *firm's* auditor must confirm to the *FSA* in writing that the *firm* has in place systems and controls which are adequate to enable it to operate the alternative approach effectively (see ■ CASS 7.4.15 R).

7.6.19 G *Firms* that do not use the *standard method of internal client money reconciliation* are reminded that the *firm's* auditor must confirm to the *FSA* in writing that the *firm* has in place systems and controls which are adequate to enable it to use another method effectively (see ■ CASS 7.6.8 R).

7.7 Statutory trust

7.7.1 G 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

7.7.2 R 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.

7.8 Notification and acknowledgement of trust

Banks

7.8.1 R (1) When a *firm* opens a *client bank account*, the *firm* must give or have given written notice to the bank requesting the bank to acknowledge to it in writing that:

(a) all *money* standing to the credit of the account is held by the *firm* as trustee (or if relevant, as agent) and that the bank is not entitled to combine the account with any other account or to exercise any right of set-off or counterclaim against *money* in that account in respect of any sum owed to it on any other account of the *firm*; and

(b) the title of the account sufficiently distinguishes that account from any account containing *money* that belongs to the *firm*, and is in the form requested by the *firm*.

(2) In the case of a *client bank account* in the *United Kingdom*, if the bank does not provide the required acknowledgement within 20 *business days* after the *firm* dispatched the notice, the *firm* must withdraw all *money* standing to the credit of the account and *deposit* it in a *client bank account* with another bank as soon as possible.

Exchange, clearing house, intermediate broker or OTC counterparty

7.8.2 R (1) A *firm* which undertakes any *contingent liability investment* for *clients* through an exchange, *clearing house*, *intermediate broker* or OTC counterparty must, before the *client transaction account* is opened with the exchange, *clearing house*, *intermediate broker* or OTC counterparty:

(a) notify the *person* with whom the account is to be opened that the *firm* is under an obligation to keep *client money* separate from the *firm's* own *money*, placing *client money* in a *client bank account*;

(b) instruct the *person* with whom the account is to be opened that any *money* paid to it in respect of that transaction is to be credited to the *firm's client transaction account*; and

(c) require the person with whom the account is to be opened to acknowledge in writing that the *firm's client transaction account* is not to be combined with any other account, nor is any right of set-off to be exercised by that *person* against *money* credited to the *client transaction account* in respect of any sum owed to that person on any other account.

(2) If the *intermediate broker* or OTC counterparty does not provide the required acknowledgement within 20 *business days* of the dispatch of the notice and instruction, the *firm* must cease using the *client transaction account* with that *broker* or counterparty and arrange as soon as possible for the transfer or liquidation of any open positions and the repayment of any *money*.

7.9 Client money distribution

Application

7.9.1 R This section (the *client money (MiFID business) distribution rules*) applies to a *firm* that holds *client money* which is subject to the *client money rules* when a *primary pooling event* or a *secondary pooling event* occurs.

Purpose

7.9.2 G 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*.

Failure of the authorised firm: primary pooling event

7.9.3 G 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 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* 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*.

7.9.4 R A *primary pooling event* occurs:

(1) on the *failure* of the *firm*;

(2) on the vesting of assets in a *trustee* in accordance with an 'assets *requirement*' imposed under section 48(1)(b) of the *Act*;

(3) on the coming into force of a *requirement* for all *client money* held by the *firm*; or

(4) when the *firm* notifies, or is in breach of its duty to notify, the *FSA*, in accordance with ■ CASS 7.6.16 R (Notification requirements), that it is unable correctly to identify and allocate in its records all valid claims arising as a result of a *secondary pooling event*.

7.9.5 R ■ CASS 7.9.4 R (4) does not apply so long as:

(1) the *firm* is taking steps, in consultation with the *FSA*, to establish those records; and

(2) there are reasonable grounds to conclude that the records will be capable of rectification within a reasonable period.

Pooling and distribution

7.9.6 R 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.

7.9.7 R (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*.

7.9.8 G 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*.

Client money received after the failure of the firm

7.9.9 R *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*.

7.9.10 G *Client money* received after the *primary pooling event* relating to an unsettled transaction should be used to settle that transaction. Examples of such transactions include:

(1) an equity transaction with a trade date before the date of the *primary pooling event* and a settlement date after the date of the *primary pooling event*; or

(2) a *contingent liability investment* that is 'open' at the time of the *primary pooling event* and is due to settle after the *primary pooling event*.

7.9.11 R 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.

7.9.12 G Whenever possible the *firm* should seek to split a *mixed remittance* before the relevant accounts are credited.

Failure of a bank, intermediate broker, settlement agent or OTC counterparty: secondary pooling events

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

7.9.14 R A *secondary pooling event* occurs on the *failure* of a third party to which *client money* held by the *firm* has been transferred under ■ CASS 7.4.1 R (1) to ■ CASS 7.4.1 R (3) (Depositing client money) or ■ CASS 7.5.2 R (Transfer of client money to a third party).

7.9.15 R ■ CASS 7.9.19 R to ■ CASS 7.9.31 R do not apply if, on the *failure* of the third party, the *firm* repays to its *clients* or pays into a *client bank account*, at an unaffected bank, an amount equal to the amount of *client money* which would have been held if a *shortfall* had not occurred at that third party.

7.9.16 G When *client money* is transferred to a third party, a *firm* continues to owe fiduciary duties to the *client*. Whether a *firm* is liable for a *shortfall* in *client money* caused by a third party failure will depend on whether it has complied with its duty of care as agent or trustee.

Failure of a bank

7.9.17 G When a bank *fails* and the *firm* decides not to make good the *shortfall* in the amount of *client money* held at that bank, a *secondary pooling event* will occur in accordance with ■ CASS 7.9.19 R. The *firm* would be expected to reflect the *shortfall* that arises at the *failed* bank in its records of the entitlement of *clients* and of *money* held with third parties.

7.9.18 G The *client money (MiFID business) distribution rules* seek to ensure that *clients* who have previously specified that they are not willing to accept the risk of the bank that has *failed*, and who therefore requested that their *client money* be placed in a *designated client bank account* at a different bank, should not suffer the loss of the bank that has *failed*.

Failure of a bank: pooling

7.9.19 R If a *secondary pooling event* occurs as a result of the *failure* of a bank where one or more *general client bank accounts* are held, then:

(1) in relation to every *general client bank account* of the *firm*, the provisions of ■ CASS 7.9.21 R, ■ CASS 7.9.26 R and ■ CASS 7.9.27 R will apply;

(2) in relation to every *designated client bank account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7.9.23 R, ■ CASS 7.9.26 R and ■ CASS 7.9.27 R will apply;

(3) in relation to each *designated client fund account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7.9.24 R, ■ CASS 7.9.26 R and ■ CASS 7.9.27 R will apply;

(4) any *money* held at a bank, other than the bank that has *failed*, in *designated client bank accounts*, is not pooled with any other *client money*; and

(5) any *money* held in a *designated client fund account*, no part of which is held by the bank that has *failed*, is not pooled with any other *client money*.

7.9.20 R If a *secondary pooling event* occurs as a result of the *failure* of a bank where one or more *designated client bank accounts* or *designated client fund accounts* are held, then:

(1) in relation to every *designated client bank account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7.9.23 R, ■ CASS 7.9.26 R and ■ CASS 7.9.27 R will apply; and

(2) in relation to each *designated client fund account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7.9.24 R, ■ CASS 7.9.26 R and ■ CASS 7.9.27 R will apply.

7.9.21 R *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 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance) (as described in ■ CASS 7.6.6 G).

7.9.22 G 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.

7.9.23 R For each *client* with a *designated client bank account* held at the *failed* bank:

(1) any *shortfall* in *client money* held, or which should have been held, in *designated client bank accounts* that has arisen as a result of the *failure*, must be borne by all the *clients* whose *client money* is held in a *designated client bank account* of the *firm* at the *failed* bank, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each of the relevant *clients* by the *firm*, 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 4.1.1

R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance) (as described in ■ CASS 7.6.6 G).

7.9.24 R *Money* held in each *designated client fund account* with the *failed bank* must be treated as pooled with any other *designated client fund accounts* of the *firm* which contain part of the same designated fund and:

(1) any *shortfall* in *client money* held, or which should have been held, in *designated client fund accounts* that has arisen as a result of the *failure*, must be borne by each of the *clients* whose *client money* is held in that designated fund, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each *client* by the *firm*, in accordance with (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 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance) (as described in ■ CASS 7.6.6 G).

7.9.25 R A *client* whose *money* was held, or which should have been held, in a *designated client bank account* with a bank that has *failed* is not entitled to claim in respect of that *money* against any other *client bank account* or *client transaction account* of the *firm*.

Client money received after the failure of a bank

7.9.26 R *Client money* received by the *firm* after the *failure* of a bank, that would otherwise have been paid into a *client bank account* at that bank:

(1) must not be transferred to the *failed* bank unless specifically instructed by the *client* in order to settle an obligation of that *client* to the *failed* bank; and

(2) must be, subject to (1), placed in a separate *client bank account* that has been opened after the *secondary pooling event* and either:

(a) on the written instruction of the *client*, transferred to a bank other than the one that has *failed*; or

(b) returned to the *client* as soon as possible.

7.9.27 R If a *firm* receives a *mixed remittance* after the *secondary pooling event* which consists of *client money* that would have been paid into a *general client bank account*, a *designated client bank account* or a *designated client fund account* maintained at the bank that has *failed*, it must:

(1) pay the full sum into a *client bank account* other than one operated at the bank that has *failed*; and

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

7.9.28 G Whenever possible the *firm* should seek to split a *mixed remittance* before the relevant accounts are credited.

Failure of an intermediate broker, settlement agent or OTC counterparty: Pooling

7.9.29 R If a *secondary pooling event* occurs as a result of the *failure* of an *intermediate broker*, *settlement agent* or OTC counterparty, then in relation to every *general client bank account* and *client transaction account* of the *firm*, the provisions of ■ CASS 7.9.30 R and ■ CASS 7.9.31 R will apply.

7

7.9.30 R *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 account*, that has arisen as a result of the *failure*, must be borne by all the *clients* whose *client money* is held in either a *general client bank account* or a *client transaction accounts* 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 of (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 intermediate broker*, *settlement agent* or OTC counterparty 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 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance) (as described in ■ CASS 7.6.6 G).

Client money received after the failure of an intermediate broker, settlement agent or OTC counterparty

7.9.31 R *Client money* received by the *firm* after the *failure* of an *intermediate broker*, *settlement agent* or OTC counterparty, that would otherwise have been paid into a *client transaction account* at that *intermediate broker*, *settlement agent* or OTC counterparty:

(1) must not be transferred to the *failed* third party unless specifically instructed by the *client* in order to settle an obligation of that *client* to the *failed intermediate broker*, *settlement agent* or OTC counterparty; and

(2) must be, subject to (1), placed in a separate *client bank account* that has been opened after the *secondary pooling event* and either:

(a) on the written instruction of the *client*, transferred to a third party other than the one that has *failed*; or

(b) returned to the *client* as soon as possible.

Notification to the FSA: failure of a bank, intermediate broker, settlement agent or OTC counterparty

7.9.32 R On the *failure* of a third party with which *money* is held, a *firm* must notify the *FSA*:

(1) as soon as it becomes aware of the *failure* of any bank, *intermediate broker*, *settlement agent*, OTC counterparty or other entity with which it has placed, or to which it has passed, *client money*; and

(2) as soon as reasonably practical, whether it intends to make good any *shortfall* that has arisen or may arise and of the amounts involved.

Annex 1

As explained in CASS 7.6.6 G, in complying with its obligations under CASS 7.6.2 R (Records and accounts), SYSC 4.1.1 G (General organisational requirements) and SYSC 6.1.1 R (Compliance), a *firm* should carry out internal reconciliations of records and accounts of *client money* the *firm* holds in *client bank accounts* and *client transaction accounts*. This Annex sets out a method of reconciliation that the *FSA* believes is appropriate for these purposes (the *standard method of internal client money reconciliation*).

1. Each *business day*, a *firm* that adopts the normal approach (see CASS 7.4.17 G) should check whether its *client money* resource, being the aggregate balance on the *firm's client bank accounts*, as at the close of business on the previous *business day*, was at least equal to the *client money* requirement, as defined in paragraph 6 below, as at the close of business on that day.

2. Each *business day*, a *firm* that adopts the alternative approach (see CASS 7.4.18 G) should ensure that its *client money* resource, being the aggregate balance on the *firm's client bank accounts*, as at the close of business on that *business day* is at least equal to the *client money* requirement, as defined in paragraph 6 below, as at the close of business on the previous *business day*.

3. No excess or *shortfall* should arise when adopting the alternative approach.

4. If a *firm* is operating the alternative approach and draws a cheque on its own bank account, it will be expected to account for those cheques that have not yet cleared when performing its reconciliations of records and accounts under paragraph 2. An historic average estimate of uncleared cheques may be used to satisfy this obligation (see CASS 7.4.19 G (3)).

5. For the purposes of performing its reconciliations of records and accounts under paragraphs 1 or 2, a *firm* should use the values contained in its accounting records, for example its cash book, rather than values contained in statements received from its banks and other third parties.

Client money requirement

6. The *client money* requirement is either:

(1) (subject to paragraph 18) the sum of, for all *clients*:

(a) the individual *client* balances calculated in accordance with paragraph 7, excluding:

(i) individual *client* balances which are negative (that is, debtors); and

(ii) *clients' equity balances*; and

(b) the total *margined transaction* requirement calculated in accordance with paragraph 14; or

(2) the sum of:

(a) for each *client bank account*:

(i) the amount which the *firm's* records show as held on that account; and

(ii) an amount that offsets each negative net amount which the *firm's* records show attributed to that account for an individual *client*; and

(b) the total *margined transaction* requirement calculated in accordance with paragraph 14.

General transactions

The individual *client* balance for each *client* should be calculated in accordance with this table:

Individual client balance calculation	
Free *money* (no trades) and	A
sale proceeds due to the *client*	
(a) in respect of *principal deals* when the *client* has delivered the *designated investments*, and	B
(b) in respect of agency *deals*, when either:	
(i) the sale proceeds have been received by the *firm* and the *client* has delivered the *designated investments*, or	C1
(ii) the *firm* holds the *designated investments* for the *client*, and	C2
the cost of purchases	
(c) in respect of *principal deals*, paid for by the *client* but the *firm* has not delivered the *designated investments* to the client, and	D
(d) in respect of agency *deal*, paid for by the *client* when either:	
(i) the *firm* has not remitted the *money* to, or to the order of, the counterparty, or	E1
(ii) the *designated investments* have been received by the *firm* but have not been delivered to the *client*,	E2
Less:	
money owed by the *client* in respect of unpaid purchases by or for the *client* if delivery of those *designated investments* has been made to the *client*, and	F
Proceeds remitted to the *client* in respect of sales transactions by or for the *client* if the *client* has not delivered the *designated investments*	G
Individual *Client* Balance 'X' = (A+B+C1+C2+D+E1+E2)-F-G	X

8. A *firm* should calculate the individual *client* balance using the contract value of any *client* purchases or sales.

9. A *firm* may choose to segregate *designated investments* instead of the value identified in paragraph 7 (except E1) if it ensures that the *designated investments* are held in such a manner that the *firm* cannot use them for its own purposes.

10. Segregation in the context of paragraph 9 can take many forms, including the holding of a *safe custody investment* in a nominee name and the safekeeping of certificates evidencing title in a fire resistant safe. It is not the intention that all the *custody rules* in the *MiFID custody chapter* should be applied to *designated investments* held in the course of settlement.

11. In determining the *client money* requirement under paragraph 6, a *firm* need not include *money* held in accordance with ■ CASS 7.2.8 R (Delivery versus payment transaction).

12. In determining the *client money* requirement under paragraph 6, a *firm*:

(1) should include dividends received and interest earned and allocated;

(2) may deduct outstanding *fees*, calls, rights and interest charges and other amounts owed by the *client* which are due and payable to the *firm* (see ■ CASS 7.2.9 R);

(3) need not include *client money* in the form of *client* entitlements which are not required to be segregated (see ■ CASS 7.4.27 G) nor include *client money* forwarded to the *firm* by its appointed representatives, *tied agents*, field representatives and other agents, but not received (see ■ CASS 7.4.24 G);

(4) should take into account any *client money* arising from ■ CASS 7.6.13 R (Reconciliation discrepancies); and

(5) should include any unallocated *client money*.

Equity balance

13. A *firm's* equity balance, whether with an exchange, *intermediate broker* or *OTC* counterparty, is the amount which the *firm* would be liable to pay to the exchange, *intermediate broker* or *OTC* counterparty (or vice-versa) in respect of the *firm's margined transactions* if each of the open positions of the *firm's clients* was liquidated at the closing or settlement prices published by the relevant exchange or other appropriate pricing source and the *firm's* account with the exchange, *intermediate broker* or *OTC* counterparty is closed.

Margined transaction requirement

14. The total *margined transaction* requirement is:

(1) the sum of each of the *client's equity balances* which are positive;

Less

(2) the proportion of any individual negative *client equity balance* which is secured by *approved collateral*; and

(3) the net aggregate of the *firm's* equity balance (negative balances being deducted from positive balances) on transaction accounts for *customers* with exchanges, *clearing houses*, *intermediate brokers* and *OTC* counterparties.

15. To meet a shortfall that has arisen in respect of the requirement in paragraph 6(1)(b) or 6(2)(b), a *firm* may utilise its own *approved collateral* provided it is held on terms specifying when it is to be realised for the benefit of *clients*, it is clearly identifiable from the *firm's* own property and the relevant terms are evidenced in writing by the *firm*. In addition, the proceeds of the sale of that *collateral* should be paid into a *client bank account*.

16. If a *firm's* total *margined transaction* requirement is negative, the *firm* should treat it as zero for the purposes of calculating its *client money* requirement.

17. The terms '*client equity balance*' and '*firm's* equity balance' in paragraph 13 refer to cash values and do not include non-cash *collateral* or other *designated investments* held in respect of a *margined transaction*.

17A. A *firm* with a *Part 30 exemption order* which also operates an LME bond arrangement for the benefit of US-resident investors, should exclude the *client equity balances* for transactions undertaken on the London Metal Exchange on behalf of those US-resident investors from the calculation of the *margined transaction* requirement.

Reduced client money requirement option

18.

(1) When, in respect of a *client*, there is a positive individual *client* balance and a negative *client equity balance*, a *firm* may offset the credit against the debit and hence have a reduced individual *client* balance in paragraph 7 for that *client*.

(2) When, in respect of a *client*, there is a negative individual *client* balance and a positive *client equity balance*, a firm may offset the credit against the debit and hence have a reduced *client equity balance* in paragraph 14 for that *client*.

19. The effect of paragraph 18 is to allow a *firm* to offset, on a *client* by *client* basis, a negative amount with a positive amount arising out of the calculations in paragraphs 7 and 14, and, by so doing, reduce the amount the *firm* is required to segregate.

Chapter 7

Client money rules

7.1 Application and Purpose

Application

7.1.1 R This chapter (the *client money rules*) applies to a *firm* that receives *money* from or holds *money* for, or on behalf of, a *client* in the course of, or in connection with:

(1) [deleted]

(a) [deleted]

(b) [deleted]

(2) [deleted]

(3) its *MiFID business*; and/or

(4) its *designated investment business*, that is not *MiFID business* in respect of any *investment agreement* entered into, or to be entered into, with or for a *client*;

unless otherwise specified in this section.

7.1.2 G [deleted]

Opt-in to the client money rules

7.1.3 R (1) A *firm* that receives or holds *money* to which this chapter applies in relation to:

(a) its *MiFID business*; or

(b) its *MiFID business* and its *designated investment business* which is not *MiFID business*;

and holds *money* in respect of which ■ CASS 5 applies, may elect to comply with the provisions of this chapter in respect of all such *money* and if it does so, this chapter applies as if all such *money* were *money* that the *firm* receives and holds in the course of, or in connection with, its *MiFID business*.

(1A) [deleted]

(1B) A *firm* that receives or holds *money* to which this chapter applies solely in relation to its *designated investment business* which is not *MiFID business* and receives or holds *money* in respect of which the *insurance client money chapter* applies, may elect to comply with the provisions of this chapter in respect of all such *money* and if it does so, this chapter applies as if all such *money* were *money* that the *firm* receives and holds in the course of or in connection with its *designated investment business*.

(2) A *firm* must make and retain a written record of any election it makes under this *rule*, including the date from which the election is to be effective. The *firm* must make the record on the date it makes the election and must keep it for a period of five years after ceasing to use it.

7.1.4 G The opt-in to the *client money rules* inthis chapter does not apply in respect of *money* that a *firm* holds outside of the scope of the *insurance client money chapter*.

7.1.5 G If a *firm* has opted to comply with this chapter, the *insurance client money chapter* will have no application to the activities to which the election applies.

7.1.6 G A *firm* that is only subject to the *insurance client money chapter* may not opt to comply with this chapter.

7.1.7 G [deleted]

7.1.7A G [deleted]

Professional client opt-out

7.1.7B R ■ CASS 7.1.7C G to ■ CASS 7.1.7I G do not apply to a *firm* in relation to *money* held in connection with its *MiFID business* to which this chapter applies or in relation to *money* for which the *firm* has made an election under ■ CASS 7.1.3 R (1).

Money that is not client money: 'opt outs' for any business other than *insurance mediation activity*

7.1.7C G The 'opt out' provisions provide a *firm* with the option of allowing a *professional client* to choose whether their *money* is subject to the *client money rules* (unless the *firm* is conducting *insurance mediation activity*).

7.1.7D R Subject to ■ CASS 7.1.7F R, *money* is not *client money* when a *firm* (other than a *sole trader*) holds that *money* on behalf of, or receives it from, a *professional client*, other than in the course of *insurance mediation activity*,

and the *firm* has obtained written acknowledgement from the *professional client* that:

(1) *money* will not be subject to the protections conferred by the *client money rules*;

(2) as a consequence, this *money* will not be segregated from the *money* of the *firm* in accordance with the *client money rules* and will be used by the *firm* in the course of its own business; and

(3) the *professional client* will rank only as a general creditor of the *firm*.

'Opt-outs' for non-IMD business

7.1.7E G For a *firm* whose business is not governed by the *Insurance Mediation Directive*, it is possible to 'opt out' on a one-way basis. However, in order to maintain a comparable regime to that applying to *MiFID business*, all '*MiFID* type' business undertaken outside the scope of *MiFID*, should comply with the *client money rules* or be 'opted out' on a two-way basis.

7.1.7F R *Money* is not *client money* if a *firm*, in respect of *designated investment business* which is not an *investment service or activity*, an *ancillary service*, a *listed activity* or *insurance mediation activity*:

(1) holds it on behalf of or receives it from a *professional client* who is not an *authorised person*; and

(2) has sent a separate written notice to the *professional client* stating the matters set out in ■ CASS 7.1.7DR (1) to ■ CASS 7.1.7DR (3).

7.1.7G G When a *firm* undertakes a range of business for a *professional client* and has separate agreements for each type of business undertaken, the *firm* may treat *client money* held on behalf of the *client* differently for different types of business; for example, a *firm* may, under ■ CASS 7.1.7D R or ■ CASS 7.1.7F R, elect to segregate *client money* in connection with *securities* transactions and not segregate (by complying with ■ CASS 7.1.7D R or ■ CASS 7.1.7F R) *money* in connection with *contingent liability investments* for the same *client*.

7.1.7H R When a *firm* transfers *client money* to another *person*, the *firm* must not enter into an agreement under ■ CASS 7.1.7D R or ■ CASS 7.1.7F R with that other *person* in relation to that *client money* or represent to that other *person* that the *money* is not *client money*.

7.1.7I G ■ CASS 7.1.7H R prevents a *firm*, when passing *client money* to another *person* under ■ CASS 7.5.2 R (transfer of client money to a third party), from making use of the 'opt out' provisions under ■ CASS 7.1.7D R or ■ CASS 7.1.7F R.

Credit institutions and approved banks

7.1.8 R The *client money rules* do not apply to a *BCD credit institution* in relation to deposits within the meaning of the *BCD* held by that *institution*.

[Note: article 13(8) of *MiFID* and article 18(1) of the *MiFID implementing Directive*]

7.1.9 G If a *credit institution* that holds *money* as a deposit with itself is subject to the *requirement to disclose information before providing services*, it should, in compliance with that obligation, notify the *client* that:

(1) *money* held for that *client* in an account with the *credit institution* will be held by the *firm* as banker and not as trustee (or in Scotland as agent); and

(2) as a result, the *money* will not be held in accordance with the *client money rules*.

7.1.10 G Pursuant to *Principle* 10 (Clients' assets), a *credit institution* that holds *money* as a deposit with itself should be able to account to all of its *clients* for amounts held on their behalf at all times. A bank account opened with the *firm* that is in the name of the *client* would generally be sufficient. When *money* from *clients* deposited with the *firm* is held in a pooled account, this account should be clearly identified as an account for *clients*. The *firm* should also be able to demonstrate that an amount owed to a specific *client* that is held within the pool can be reconciled with a record showing that individual's *client* balance and is, therefore, identifiable at any time. Similarly, where that *money* is reflected only in a *firm's* bank account with other banks (nostro accounts), the *firm* should be able to reconcile amounts owed to that *client* within a reasonable period of time.

7.1.11 G A *credit institution* is reminded that the exemption for deposits is not an absolute exemption from the *client money rules*.

7.1.11A R (1) This *rule* applies to a *firm* which is an *approved bank* but not a *BCD credit institution*.

(2) The *client money rules* do not apply to money held by the *approved bank* if it is undertaking business which is not *MiFID business* but only when the money is held in an account with itself, in which case the *firm* must notify the *client* in writing that:

(a) *money* held for that *client* in an account with the *approved bank* will be held by the *firm* as banker and not as trustee (or in Scotland as agent); and

(b) as a result, the *money* will not be held in accordance with the *client money rules*.

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Affiliated companies - MiFID business

7.1.12 G A *firm* that holds *money* on behalf of, or receives *money* from, an *affiliated company* in respect of *MiFID business* must treat the *affiliated company* as any other *client* of the *firm* for the purposes of this chapter.

Affiliated companies - non-MiFID business

7.1.12A R A *firm* that holds *money* on behalf of, or receives *money* from, an *affiliated company* in respect of *designated investment business* which is not *MiFID business* must not treat the *money* as *client money* unless:

(1) the *firm* has been notified by the *affiliated company* that the *money* belongs to a *client* of the *affiliated company*; or

(2) the *affiliated company* is a *client* dealt with at arm's length; or

(3) the *affiliated company* is a manager of an *occupational pension scheme* or is an overseas company; and

(a) the *money* is given to the *firm* in order to carry on *designated investment business* for or on behalf of the *clients* of the *affiliated company*; and

(b) the *firm* has been notified by the *affiliated company* that the *money* is to be treated as *client money*.

7.1.13 G [deleted]

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Coins

7.1.14 R The *client money rules* do not apply with respect to coins held on behalf of a *client* if the *firm* and the *client* have agreed that the *money* (or *money* of that type) is to be held by the *firm* for the intrinsic value of the metal which constitutes the coin.

Solicitors

7.1.15 R (1) An *authorised professional firm* regulated by the Law Society (of England and Wales), the Law Society of Scotland or the Law Society of Northern Ireland must comply with the following rules of its *designated professional body* and, where relevant paragraph (3), and if it does so, it will be deemed to comply with the *client money rules*.

(2) The relevant rules are:

(a) if the *firm* is regulated by the Law Society (of England and Wales):

(i) the Solicitors' Accounts Rules 1998; or

(ii) where applicable, the Solicitors Overseas Practice Rules 1990;

(b) if the *firm* is regulated by the Law Society of Scotland, the Solicitors' (Scotland) Accounts, Accounts Certificate, Professional Practice and Guarantee Fund Rules 2001; and

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(c) if the *firm* is regulated by the Law Society of Northern Ireland, the Solicitors' Accounts Regulations 1998.

(3) If the *firm* in (1) is a *MiFID investment firm* that receives or holds *money* for, or on behalf of a client in the course of, or in connection with its *MiFID business*, it must also comply with the *MiFID client money (minimum implementing) rules* in relation to that business.

Long term insurers and friendly societies

7.1.15A R This chapter does not apply to the *permitted activities* of a *long-term insurer* or a *friendly society*, unless it is a *MiFID investment firm* that receives *money* from or holds *money* for or on behalf of a *client* in the course of, or in connection with, its *MiFID business*.

Contracts of insurance

7.1.15B R This chapter does not apply to *client money* held by a *firm* which:

(1) receives or holds *client money* in relation to *contracts of insurance*; but which

(2) in relation to such *client money* elects to act in accordance with the *insurance client money chapter*.

7.1.15C R A *firm* should make and retain a written record of any election which it makes under ■ CASS 7.1.15B R.

Life assurance business

7.1.15D G (1) A *firm* which receives and holds *client money* in respect of life assurance business in the course of its *designated investment business* that is not *MiFID business* may:

(a) under ■ CASS 7.1.3 R (1B) elect to comply with the *client money chapter* in respect of such *client money* and in doing so avoid the need to comply with the *insurance client money chapter* which would otherwise apply to the *firm* in respect of *client money* received in the course of its *insurance mediation activity*; or

(b) under ■ CASS 7.1.15B R, elect to comply with the *insurance client money chapter* in respect of such *client money*.

(2) These options are available to a *firm* irrespective of whether it also receives and holds *client money* in respect of other parts of its *designated investment business*. A *firm* may not however choose to comply with the *insurance client money chapter* in respect of *client money* which it receives and holds in the course of any part of its *designated investment business* which does not involve an *insurance mediation activity*.

Trustee firms (other than trustees of unit trust schemes)

7.1.15E R A *trustee firm* which holds *money* in relation to its *designated investment business* which is not *MiFID business* to which this chapter applies, must hold any such *client money* separate from its own *money* at all times.

7.1.15F R Only the *client money rules* listed in the table below apply to a *trustee firm* in connection with *money* that the firm receives, or holds for or on behalf of a client in the course of or in connection with its *designated investment business* which is not *MiFID business*.

Reference	Rule
CASS 7.1.1 R to CASS 7.1.6 G, and CASS 7.1.8 R to CASS 7.1.14 R	Application
CASS 7.1.15E R and CASS 7.1.15F R	Trustee firms (other than trustees of unit trust schemes)
CASS 7.1.16 G	General principle
CASS 7.7.2 R to CASS 7.7.4 G	Requirement
CASS 7.4.1 R to CASS 7.4.6 G	Depositing client money
CASS 7.4.7 R to CASS 7.4.13 G	A firm's selection of credit institution, bank or money market fund
CASS 7.6.6 G to CASS 7.6.16 R	Reconciliation of client money balances

General purpose

7.1.16 G (1) *Principle* 10 (Clients' assets) requires a *firm* to arrange adequate protection for *clients*' assets when 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 where relevantimplement the provisions of *MiFID* which regulate the obligations of a *firm* when it holds *client money* in the course of its *MiFID business*.

7.2 Definition of client money

7.2.1 R [deleted]

7.2.2 R [deleted]

Title transfer collateral arrangements

7.2.3 R **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*.**

[Note: recital 27 to *MiFID*]

7.2.4 G A title transfer financial collateral arrangement under the *Financial Collateral Directive* is an example of a type of transfer of *money* to cover obligations where that *money* will not be regarded as *client money*.

7.2.5 G Where a *firm* has received full title or full ownership to *money* under a collateral arrangement, the fact that it has also taken a security interest over its obligation to repay that *money* to the *client* would not result in the *money* being *client money*. This can be compared to a situation in which a *firm* takes a charge or other security interest over *money* held in a *client bank account*, where that *money* would still be *client money* as there would be no absolute transfer of title to the *firm*. However, if that security interest includes a "right to use arrangement", under which the *client* agrees to transfer all of its rights to *money* in that account to the *firm* upon the exercise of the right to use, the *money* may cease to be *client money*, but only once the right to use is exercised and the *money* is transferred out of the account to the *firm*.

7.2.6 G *Firms* are reminded of the *client's best interest rule*, which requires a *firm* to act honestly, fairly and professionally in accordance with the best interests of its *clients* when structuring its business particularly in respect of the effect of that structure on *firms'* obligations under the *client money rules*.

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7.2.7 G Pursuant to the *client's best interests rule*, a *firm* should ensure that where a *retail client* transfers full ownership of *money* to a *firm*:

(1) the *client* is notified that full ownership of the *money* has been transferred to the *firm* and, as such, the *client* no longer has a proprietary claim over this *money* and the *firm* can deal with it on its own right;

(2) the transfer is for the purposes of securing or covering the *client's* obligations;

(3) an equivalent transfer is made back to the *client* if the provision of collateral by the *client* is no longer necessary; and

(4) there is a reasonable link between the timing and the amount of the collateral transfer and the obligation that the *client* owes, or is likely to owe, to the *firm*.

Money in connection with a "delivery versus payment" transaction

7.2.8 R *Money* need not be treated as *client money* in respect of a delivery versus payment transaction through a commercial settlement system if it is intended that either:

(1) in respect of a *client's* purchase, *money* from a *client* will be due to the *firm* within one *business day* upon the fulfilment of a delivery obligation; or

(2) in respect of a *client's* sale, *money* is due to the *client* within one *business day* following the *client's* fulfilment of a delivery obligation;

unless the delivery or payment by the *firm* does not occur by the close of business on the third *business day* following the date of payment or delivery of the *investments* by the *client*.

7.2.8A G The exclusion from the *client money rules* for delivery versus payment transactions under ■ CASS 7.2.8 R is an example of an exclusion from the *client money rules* which is permissible by virtue of recital 26 of *MiFID*.

7.2.8B R *Money* need not be treated as *client money* in respect of a delivery versus payment transaction, for the purpose of settling a transaction in relation to *units* in a *regulated collective investment scheme*, if:

(1) the *authorised fund manager* receives it from a *client* in relation to the *authorised fund manager's* obligation to issue *units*, in an *AUT* or to arrange for the issue of *units* in an *ICVC*, in accordance with *COLL*, unless the *price* of those *units* has not been determined by the close of business on the next *business day*:

(a) following the date of the receipt of the *money* from the *client*; or

(b) if the *money* was received by an *appointed representative* of the *authorised fund manager*, in accordance with ■ CASS 7.4.24 G, following the date of receipt at the specified business address of the *authorised fund manager*; or

(2) the *money* is held in the course of redeeming *units* where the proceeds of that redemption are paid to a *client* within the time specified in *COLL*; when an *authorised fund manager* draws a cheque or other payable order within these time frames the provisions of ■ CASS 7.2.17 R and ■ CASS 7.2.9 R (2) will not apply.

Money due and payable to the firm

7.2.9 R

(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*.

7.2.10 G *Money* held as *client money* becomes due and payable to the *firm* or for the *firm's* own account, for example, because the *firm* acted as *principal* in the contract or the *firm*, acting as agent, has itself paid for *securities* in advance of receiving the purchase *money* from its *client*. The circumstances in which it is due and payable will depend on the contractual arrangement between the *firm* and the *client*.

7.2.11 G When a *client's* obligation or liability, that is secured by that *client's* asset, crystallises, and the *firm* realises the asset in accordance with an agreement entered into between the *client* and the *firm*, the part of the proceeds of the asset to cover such liability that is due and payable to the *firm* is not *client* money. However, any proceeds of sale in excess of the amount owed by the *client* to the *firm* should be paid over to the *client* immediately or be held in accordance with the *client money rules*.

Commission rebate

7.2.12 G When a *firm* has entered into an arrangement under which *commission* is rebated to a *client*, those rebates need not be treated as *client money* until they become due and payable to the *client* in accordance with the terms of the contractual arrangements between the parties.

7.2.13 G When *commission* rebate becomes due and payable to the *client*, the *firm* should:

(1) treat it as *client money*; 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);

unless the *firm* and the *client* have entered into an arrangement under which the *client* has agreed to transfer full ownership of this *money* to the *firm* as collateral against payment of future professional fees (see ■ CASS 7.2.3 R (Title transfer collateral arrangements)).

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Interest

7.2.14 R Unless a *firm* notifies a *retail client* in writing whether or not interest is to be paid on *client money* and, if so, on what terms and at what frequency,

it must pay that *client* all interest earned on that *client money*. Any interest due to a *client* will be *client money*.

Discharge of fiduciary duty

7.2.15 R *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*, unless it is transferred to a third party in the course of effecting a transaction, in accordance with ■ CASS 7.5.2 R (Transfer of client money to a third party); or

(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 ■ CASS 7.2.9 R (Money due and payable to the firm)); or

(5) to the *firm* itself, when it is an excess in the *client bank account* (see ■ CASS 7.6.13 R (2) (Reconciliation discrepancies)).

7.2.16 G When a *firm* wishes to transfer *client money* balances to a third party in the course of transferring its business to another *firm*, it should do so in a way which it discharges its fiduciary duty to the *client* under this section.

7.2.17 R When a *firm* draws a cheque or other payable order to discharge its fiduciary duty 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.

Allocated but unclaimed client money

7.2.18 G The purpose of the *rule* on allocated but unclaimed *client money* is to allow a *firm*, in the normal course of its business, to cease to treat as *client money* any balances, allocated to an individual *client*, when those balances remain unclaimed.

7.2.19 R A *firm* may cease to treat as *client money* any unclaimed *client money* balance if it can demonstrate that it has taken reasonable steps to trace the *client* concerned and to return the balance.

7.2.20 E (1) Reasonable steps should include:

(a) entering into a written agreement, in which the *client* consents to the *firm* releasing, after the period of time specified in (b), any *client money* balances, for or on behalf of that *client*, from *client bank accounts*;

(b) determining that there has been no movement on the *client's* balance for a period of at least six years (notwithstanding any payments or receipts of charges, interest or similar items);

(c) writing to the *client* at the last known address informing the *client* of the *firm's* intention of no longer treating that balance as *client money*, giving the *client* 28 days to make a claim;

(d) making and retaining records of all balances released from *client bank accounts*; and

(e) undertaking to make good any valid claim against any released balances.

(2) Compliance with (1) may be relied on as tending to establish compliance with ■ CASS 7.2.19 R.

(3) Contravention of (1) may be relied on as tending to establish contravention of ■ CASS 7.2.19 R.

7.2.21 G When a *firm* gives an undertaking to make good any valid claim against released balances, it should make arrangements authorised by the *firm's* relevant *controllers* that are legally enforceable by any *person* with a valid claim to such *money*.

7.3 Organisational requirements: client money

Requirement to protect client money

7.3.1 R 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*]

7.4 Segregation of client money

Depositing client money

7.4.1 R 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;

(4) a *qualifying money market fund*.

[Note: article 18(1) of the *MiFID implementing Directive*]

7.4.2 G An account with a central bank, a *BCD credit institution* or a bank authorised in a third country in which *client money* is placed is a *client bank account*.

Qualifying money market funds

7.4.3 G Where a *firm* deposits *client money* with a *qualifying money market fund*, the units in that fund should be held in accordance with ■ CASS 6.

[Note: recital 23 to the *MiFID implementing Directive*]

7.4.4 G A *firm* that places *client money* in a *qualifying money market fund* should ensure that it has the *permissions* required to invest in and hold units in that fund and must comply with the *rules* that are relevant for those activities.

7.4.5 R A *firm* must give a *client* the right to oppose the placement of his *money* in a *qualifying money market fund*.

[Note: article 18(3) of the *MiFID implementing Directive*]

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7.4.6 G If a *firm* that intends to place *client money* in a *qualifying money market fund* is subject to the *requirement to disclose information before providing services*, it should, in compliance with that obligation, notify the *client* that:

(1) *money* held for that *client* will be held in a *qualifying money market fund*; and

(2) as a result, the *money* will not be held in accordance with the *client money rules* but in accordance with the *custody rules*.

A firm's selection of a credit institution, bank or money market fund

7.4.7 R A *firm* that 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 and the arrangements for the holding of this *money*.

[Note: article 18(3) of the *MiFID implementing Directive*]

7.4.8 R When a *firm* makes the selection, appointment and conducts the periodic review of a *credit institution*, a bank or a *qualifying money market fund*, it must take into account:

(1) the expertise and market reputation of the third party; and

(2) any legal requirements or market practices related to the holding of *client money* that could adversely affect *clients*' rights.

[Note: article 18(3) of the *MiFID implementing Directive*]

7.4.9 G In discharging its obligations when selecting, appointing and reviewing the appointment of a *credit institution*, a bank or a *qualifying money market fund*, a *firm* should also consider, together with any other relevant matters:

(1) the need for diversification of risks;

(2) the capital of the *credit institution* or bank;

(3) the amount of *client money* placed, as a proportion of the *credit institution* or bank's capital and *deposits*, and, in the case of a *qualifying money market fund*, compared to any limit the fund may place on the volume of redemptions in any period;

(4) the credit rating of the *credit institution* or bank; and

(5) to the extent that the information is available, the level of risk in the investment and loan activities undertaken by the *credit institution* or bank and *affiliated companies*.

7.4.10 R A *firm* must make a record of the grounds upon which it satisfies itself as to the appropriateness of its selection of a *credit institution*, a bank or a *qualifying money market fund*. The *firm* must make the record on the date it makes the selection and must keep it from the date of such selection until five years after the *firm* ceases to use the third party to hold *client money*.

Client bank accounts

7.4.11 R A *firm* must take the necessary steps to ensure that *client money* deposited, in accordance with ■ CASS 7.4.1 R, in a central bank, a *credit institution*, a bank authorised in a third country or a *qualifying money market fund* is held in an account or accounts identified separately from any accounts used to hold *money* belonging to the *firm*.

[Note: article 16(1)(e) of the *MiFID implementing Directive*]

7.4.12 G 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 ■ CASS 7.9.3 G).

7.4.13 G A *designated client fund account* may be used for a *client* only where that *client* has consented to the use of that account and all other *designated client fund accounts* which may be pooled with it. For example, a *client* who consents to the use of bank A and bank B should have his *money* held in a different *designated client fund account* at bank B from a *client* who has consented to the use of banks B and C.

Payment of client money into a client bank account

7.4.14 G 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'.

7.4.15 R 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.

7.4.16 G 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* comply with its obligations to perform reconciliations of records and accounts (see ■ CASS 7.6.2 R). A *firm* that adopts the alternative approach will segregate *client money* into a *client bank account* 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*.

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7.4.17 G 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).

7.4.18 G 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), and where relevant ■ SYSC 4.1.1 R 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).

7.4.19 G 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).

7.4.20 G Pursuant to the *client money segregation requirements*, a *firm* should ensure that any *money* other than *client money* deposited in a *client bank account* is promptly paid out of that account unless it is a minimum sum required to open the account, or to keep it open.

7.4.21 R **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.**

Automated transfers

7.4.22 G Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach that receives *client money* in the form of an automated transfer should take reasonable steps to ensure that:

(1) the *money* is received directly into a *client bank account*; and

(2) if *money* is received directly into the *firm's* own account, the *money* is transferred into a *client bank account* promptly, and in any event, no later than the next *business day* after receipt.

Mixed remittance

7.4.23 G Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach that receives a *mixed remittance* (that is part *client money* and part other *money*) should:

(1) pay the full sum into a *client bank account* promptly, and in any event, no later than the next *business day* after receipt; and

(2) pay the *money* that is not *client money* out of the *client bank account* promptly, and in any event, no later than one *business day* of the day on which the *firm* would normally expect the remittance to be cleared.

Appointed representatives, tied agents, field representatives and other agents

7.4.24 G (1) Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach should establish and maintain procedures to ensure that *client money* received by its *appointed representatives*, *tied agents*, *field representatives* or other agents is:

(a) paid into a *client bank account* of the *firm* promptly, and in any event, no later than the next *business day* after receipt; or

(b) forwarded to the *firm*, or in the case of a *field representative* forwarded to a specified business address of the *firm*, so as to ensure that the *money* arrives at the specified business address promptly, and in any event, no later than the close of the third *business day*.

(2) For the purposes of 1(b), *client money* received on *business day* one should be forwarded to the *firm* or specified business address of the *firm* promptly, and in any event, no later than the next *business day* after receipt (*business day* two) in order for it to reach that *firm* or specified business address by the close of the third *business day*. Procedures requiring the *client money* in the form of a cheque to be sent to the *firm* or the specified business address of the *firm* by first class post promptly, and in any event, no later than the next *business day* after receipt, would be in line with 1(b).

7.4.25 G The *firm* should ensure that its *appointed representatives*, *tied agents*, *field representatives* or other agents keep *client money* separately identifiable from any other *money* (including that of the *firm*) until the *client money* is paid into a *client bank account* or sent to the *firm*.

7.4.26 G A *firm* that operates a number of small branches, but holds or accounts for all *client money* centrally, may treat those small branches in the same way as *appointed representatives* and *tied agents*.

Client entitlements

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7.4.27 G Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach that receives outside the *United Kingdom* a *client* entitlement on behalf of a *client* should pay any part of it which is *client money*:

(1) to, or in accordance with, the instructions of the *client* concerned; or

(2) into a *client bank account* promptly, and in any event, no later than five *business days* after the *firm* is notified of its receipt.

7.4.28 G Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach should allocate a *client* entitlement that is *client money* to the individual *client* promptly and, in any case, no later than ten *business days* after notification of receipt.

Money due to a client from a firm

7.4.29 G Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach that is liable to pay *money* to a *client* should promptly, and in any event no later than one *business day* after the *money* is due and payable, pay the *money*:

(1) to, or to the order of, the *client*; or

(2) into a *client bank account*.

Segregation in different currency

7.4.30 R **A *firm* may segregate *client money* in a different currency from that of receipt. If it does so, the *firm* must ensure that the amount held is adjusted each *day* to an amount at least equal to the original currency amount (or the currency in which the *firm* has its liability to its *clients*, if different), translated at the previous day's closing spot exchange rate.**

7.4.31 G The *rule* on segregation of *client money* in a different currency (■ CASS 7.4.30 R) does not apply where the *client* has instructed the *firm* to convert the *money* into and hold it in a different currency.

Commodity Futures Trading Commission Part 30 exemption order

7.4.32 G United States (US) legislation restricts the ability of non-US firms to trade on behalf of US customers on non-US futures and options exchanges. The relevant US regulator (the *CFTC*) operates an exemption system for *firms* authorised by the *FSA*. The *FSA* sponsors the application from a *firm* for exemption from Part 30 of the General Regulations under the US Commodity Exchange Act in line with this system. The application forms and associated information can be found on the *FSA* website in the "Forms" section.

7.4.33 G A *firm* with a *Part 30 exemption order* undertakes to the *CFTC* that it will refuse to allow any US customer to opt not to have his *money* treated as *client money* if it is held or received in respect of transactions on non-US exchanges, unless that US customer is an "eligible contract participant" as defined in section 1a(12) of the Commodity Exchange Act, 7 U.S.C. In doing so, the *firm* is representing that if available to it, it will not make use of the opt-out arrangements in ■ CASS 7.1.7B R to ■ CASS 7.1.7F R in relation to that business.

7.4.34 R **A *firm* must not reduce the amount of, or cancel a letter of credit issued under, an LME bond arrangement where this will cause the *firm* to be in breach of its *Part 30 exemption order*.**

7.4.35 R A *firm* must notify the *FSA* immediately it arranges the *issue* of an individual letter of *credit* under an LME bond arrangement.

7.5 Transfer of client money to a third party

7.5.1 G This section sets out the requirements a *firm* must comply with when it transfers *client money* to another *person* without discharging its fiduciary duty owed to that *client*. Such circumstances arise when, for example, a *firm* passes *client money* to a *clearing house* in the form of margin for the *firm's* obligations to the *clearing house* that are referable to transactions undertaken by the *firm* for the relevant clients. They may also arise when a *firm* passes *client money* to an *intermediate broker* for *contingent liability investments* in the form of initial or variation margin on behalf of a *client*. In these circumstances, the *firm* remains responsible for that *client's equity balance* held at the *intermediate broker* until the contract is terminated and all of that *client's* positions at that *broker* closed. If a *firm* wishes to discharge itself from its fiduciary duty, it should do so in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (■ CASS 7.2.15 R).

7.5.2 R A *firm* may allow another *person*, such as an exchange, a *clearing house* or an *intermediate broker*, to hold or control *client money*, but only if:

(1) the *firm* transfers the *client money*:

(a) for the purpose of a transaction for a *client* through or with that *person*; or

(b) to meet a *client's* obligation to provide collateral for a transaction (for example, an *initial margin* requirement for a *contingent liability investment*); and

(2) in the case of a *retail client*, that *client* has been notified that the *client money* may be transferred to the other *person*.

7.5.3 G A *firm* should not hold excess *client money* in its *client transaction accounts* with *intermediate brokers*, *settlement agents* and OTC counterparties; it should be held in a *client bank account*.

7.6 Records, accounts and reconciliations

Records and accounts

7.6.1 R A *firm* must keep such records and accounts as are necessary to enable it, at any time and without delay, to distinguish *client money* held for one *client* from *client money* held for any other *client*, and from its own *money*.

[Note: article 16(1)(a) of the *MiFID implementing Directive*]

7.6.2 R A *firm* must maintain its records and accounts in a way that ensures their accuracy, and in particular their correspondence to the *client money* held for *clients*.

[Note: article 16(1)(b) of the *MiFID implementing Directive*]

Client entitlements

7.6.3 G Pursuant to ■ CASS 7.6.2 R, and where relevant ■ SYSC 4.1.1 R and ■ SYSC 6.1.1 R, a *firm* should take reasonable steps to ensure that is notified promptly of any receipt of *client money* in the form of a *client* entitlement.

Record keeping

7.6.4 R A *firm* must ensure that records made under ■ CASS 7.6.1 R and ■ CASS 7.6.2 R are retained for a period of five years after they were made.

7.6.5 G A *firm* should ensure that it makes proper records, sufficient to show and explain the *firm's* transactions and commitments in respect of its *client money*.

Internal reconciliations of client money balances

7.6.6 G (1) Carrying out internal reconciliations 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 accounts* and *client transaction accounts* should be one of the steps a *firm* takes to satisfy its obligations under ■ CASS 7.6.2 R, and where relevant ■ SYSC 4.1.1 R and ■ SYSC 6.1.1 R.

(2) A *firm* should perform such internal reconciliations:

(a) as often as is necessary; and

(b) as soon as reasonably practicable after the date to which the reconciliation relates;

to ensure the accuracy of the *firm's* records and accounts.

(3) The *standard method of internal client money reconciliation* sets out 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*.

Records

7.6.7 R (1) A *firm* must make records, sufficient to show and explain the method of internal reconciliation of *client money* balances under ■ CASS 7.6.2 R used, and if different from the *standard method of internal client money reconciliation*, to show and explain that:

(a) the method of internal reconciliation of *client money* balances used affords an equivalent degree of protection to the *firm's clients* to that afforded by the *standard method of internal client money reconciliation*; and

(b) in the event of a *primary pooling event* or a *secondary pooling event*, the method used is adequate to enable the *firm* to comply with the *client money distribution rules*.

(2) A *firm* must make these records on the date it starts using a method of internal reconciliation of *client money* balances and must keep it made for a period of five years after ceasing to use it.

7.6.8 R A *firm* that does not use the *standard method of internal client money reconciliation* 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 use another method effectively.

Reconciliations with external records

7.6.9 R A *firm* must conduct, on a regular basis, reconciliations between its internal accounts and records and those of any third parties by whom *client money* is held.

[Note: article 16(1)(c) of the *MiFID implementing Directive*]

Frequency of external reconciliations

7.6.10 G (1) A *firm* should perform the required reconciliation of *client money* balances with external records:

(a) as regularly as is necessary; and

(b) as soon as reasonably practicable after the date to which the reconciliation relates;

to ensure the accuracy of its internal accounts and records against those of third parties by whom *client money* is held.

(2) In determining whether the frequency is adequate, the *firm* should consider the risks which the business is exposed, such as the nature, volume and complexity of the business, and where and with whom the *client money* is held.

Method of external reconciliations

7.6.11 G A method of reconciliation of *client money* balances with external records that the *FSA* believes is adequate is when a *firm* compares:

(1) the balance on each *client bank account* as recorded by the *firm* with the balance on that account as set out on the statement or other form of confirmation issued by the bank with which those accounts are held; and

(2) the balance, currency by currency, on each *client transaction account* as recorded by the *firm*, with the balance on that account as set out in the statement or other form of confirmation issued by the *person* with whom the account is held;

and identifies any discrepancies between them.

7.6.12 R Any *approved collateral* held in accordance with the *client money rules* must be included within this reconciliation.

Reconciliation discrepancies

7.6.13 R When any discrepancy arises as a result of a *firm's* internal reconciliations, the *firm* must identify the reason for the discrepancy and ensure that:

(1) any *shortfall* is paid into a *client bank account* by the close of business on the day that the reconciliation is performed; or

(2) any excess is withdrawn within the same time period (but see ■ CASS 7.4.20 G and ■ CASS 7.4.21 R).

7.6.14 R When any discrepancy arises as a result of the reconciliation between a *firm's* internal records and those of third parties that hold *client money*, the *firm* must identify the reason for the discrepancy and correct it as soon as possible, unless the discrepancy arises solely as a result of timing differences between the accounting systems of the party providing the statement or confirmation and that of the *firm*.

7.6.15 R While a *firm* is unable to resolve a difference arising from a reconciliation between a *firm's* internal records and those of third parties that hold *client money*, and one record or a set of records examined by the *firm* during its reconciliation indicates that there is a need to have a greater amount of *client money* or *approved collateral* than is in fact the case, the *firm* must assume, until the matter is finally resolved, that the record or set of records is accurate and pay its own *money* into a relevant account.

Notification requirements

7.6.16 R A *firm* must inform the *FSA* in writing without delay:

(1) if it has not complied with, or is unable, in any material respect, to comply with the requirements in ■ CASS 7.6.1 R, ■ CASS 7.6.2 R or ■ CASS 7.6.9 R;

(2) if having carried out a reconciliation it has not complied with, or is unable, in any material respect, to comply with ■ CASS 7.6.13 R to ■ CASS 7.6.15 R.

Audit of compliance with the MiFID client money rules

7.6.17 G *Firms* are reminded that the auditor of the *firm* has to confirm in the report submitted to the *FSA* under ■ SUP 3.10 (Duties of auditors: notification and report on client assets) that the *firm* has maintained systems adequate to enable it to comply with the *client money rules*.

7.6.18 G *Firms* that do not adopt the normal approach are reminded that the *firm's* auditor must confirm to the *FSA* in writing that the *firm* has in place systems and controls which are adequate to enable it to operate the alternative approach effectively (see ■ CASS 7.4.15 R).

7.6.19 G *Firms* that do not use the *standard method of internal client money reconciliation* are reminded that the *firm's* auditor must confirm to the *FSA* in writing that the *firm* has in place systems and controls which are adequate to enable it to use another method effectively (see ■ CASS 7.6.8 R).

7.7 Statutory trust

7.7.1 G 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

7.7.2 R 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 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.

7.7.3 R A *trustee firm* which is subject to the *client money rules* by virtue of ■ CASS 7.1.1 R (4):

(1) must receive and hold *client money* in accordance with the relevant instrument of trust;

(2) subject to that, receives and holds *client money* on trust on the terms (or in Scotland on the agency terms) specified in ■ CASS 7.7.2 R.

7.7.4 G If a *trustee firm* holds *client money* in accordance with ■ CASS 7.7.3 R (2), the *firm* should follow the provisions in ■ CASS 7.1.15E R and ■ CASS 7.1.15F R.

7.8 Notification and acknowledgement of trust

Banks

7.8.1 R (1) When a *firm* opens a *client bank account*, the *firm* must give or have given written notice to the bank requesting the bank to acknowledge to it in writing that:

(a) all *money* standing to the credit of the account is held by the *firm* as trustee (or if relevant, as agent) and that the bank is not entitled to combine the account with any other account or to exercise any right of set-off or counterclaim against *money* in that account in respect of any sum owed to it on any other account of the *firm*; and

(b) the title of the account sufficiently distinguishes that account from any account containing *money* that belongs to the *firm*, and is in the form requested by the *firm*.

(2) In the case of a *client bank account* in the *United Kingdom*, if the bank does not provide the required acknowledgement within 20 *business days* after the *firm* dispatched the notice, the *firm* must withdraw all *money* standing to the credit of the account and *deposit* it in a *client bank account* with another bank as soon as possible.

Exchanges, clearing houses, intermediary brokers or OTC counterparties

7.8.2 R (1) A *firm* which undertakes any *contingent liability investment* for *clients* through an exchange, *clearing house*, *intermediate broker* or *OTC* counterparty must, before the *client transaction account* is opened with the exchange, *clearing house*, *intermediate broker* or *OTC* counterparty:

(a) notify the *person* with whom the account is to be opened that the *firm* is under an obligation to keep *client money* separate from the *firm's* own *money*, placing *client money* in a *client bank account*;

(b) instruct the *person* with whom the account is to be opened that any *money* paid to it in respect of that transaction is to be credited to the *firm's client transaction account*; and

(c) require the person with whom the account is to be opened to acknowledge in writing that the *firm's client transaction account* is not to be combined with any other account, nor is any right of set-off to be exercised by that *person* against *money* credited to the *client transaction account* in respect of any sum owed to that person on any other account.

(2) If the exchange, *clearing house, intermediate broker* or *OTC* counterparty does not provide the required acknowledgement within 20 *business days* of the dispatch of the notice and instruction, the *firm* must cease using the *client transaction account* with that *broker* or counterparty and arrange as soon as possible for the transfer or liquidation of any open positions and the repayment of any *money*.

7.9 [Deleted]

Annex 1

As explained in ■ CASS 7.6.6 G, in complying with its obligations under ■ CASS 7.6.2 R (Records and accounts), and where relevant ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance), a *firm* should carry out internal reconciliations of records and accounts of *client money* the *firm* holds in *client bank accounts* and *client transaction accounts*. This Annex sets out a method of reconciliation that the *FSA* believes is appropriate for these purposes (the *standard method of internal client money reconciliation*).

1. Each *business day*, a *firm* that adopts the normal approach (see ■ CASS 7.4.17 G) should check whether its *client money* resource, being the aggregate balance on the *firm's client bank accounts*, as at the close of business on the previous *business day*, was at least equal to the *client money* requirement, as defined in paragraph 6 below, as at the close of business on that day.

2. Each *business day*, a *firm* that adopts the alternative approach (see ■ CASS 7.4.18 G) should ensure that its *client money* resource, being the aggregate balance on the *firm's client bank accounts*, as at the close of business on that *business day* is at least equal to the *client money* requirement, as defined in paragraph 6 below, as at the close of business on the previous *business day*.

3. No excess or *shortfall* should arise when adopting the alternative approach.

4. If a *firm* is operating the alternative approach and draws a cheque on its own bank account, it will be expected to account for those cheques that have not yet cleared when performing its reconciliations of records and accounts under paragraph 2. An historic average estimate of uncleared cheques may be used to satisfy this obligation (see ■ CASS 7.4.19 G (3)).

5. For the purposes of performing its reconciliations of records and accounts under paragraphs 1 or 2, a *firm* should use the values contained in its accounting records, for example its cash book, rather than values contained in statements received from its banks and other third parties.

Client money requirement

6. The *client money* requirement is either:

(1) (subject to paragraph 18) the sum of, for all *clients*:

(a) the individual *client* balances calculated in accordance with paragraph 7, excluding:

(i) individual *client* balances which are negative (that is, debtors); and

(ii) *clients' equity balances*; and

(b) the total *margined transaction* requirement calculated in accordance with paragraph 14; or

(2) the sum of:

(a) for each *client bank account*:

(i) the amount which the *firm's* records show as held on that account; and

(ii) an amount that offsets each negative net amount which the *firm's* records show attributed to that account for an individual *client*; and

(b) the total *margined transaction* requirement calculated in accordance with paragraph 14.

General transactions

The individual *client* balance for each *client* should be calculated in accordance with this table:

Individual client balance calculation	
Free *money* (no trades) and	A
sale proceeds due to the *client*:	
(a) in respect of *principal deals* when the *client* has delivered the *designated investments*; and	B
(b) in respect of agency *deals*, when either:	
(i) the sale proceeds have been received by the *firm* and the *client* has delivered the *designated investments*; or	C1
(ii) the *firm* holds the *designated investments* for the *client*; and	C2
the cost of purchases:	
(c) in respect of *principal deals*, paid for by the *client* but the *firm* has not delivered the *designated investments* to the client; and	D
(d) in respect of agency *deal*, paid for by the *client* when either:	
(i) the *firm* has not remitted the *money* to, or to the order of, the counterparty; or	E1
(ii) the *designated investments* have been received by the *firm* but have not been delivered to the *client*;	E2
Less	
money owed by the *client* in respect of unpaid purchases by or for the *client* if delivery of those *designated investments* has been made to the *client*; and	F
Proceeds remitted to the *client* in respect of sales transactions by or for the *client* if the *client* has not delivered the *designated investments*.	G
Individual *Client* Balance 'X' = (A+B+C1+C2+D+E1+E2)-F-G	X

8. A *firm* should calculate the individual *client* balance using the contract value of any *client* purchases or sales.

9. A *firm* may choose to segregate *designated investments* instead of the value identified in paragraph 7 (except E1) if it ensures that the *designated investments* are held in such a manner that the *firm* cannot use them for its own purposes.

10. Segregation in the context of paragraph 9 can take many forms, including the holding of a *safe custody investment* in a nominee name and the safekeeping of certificates evidencing title in a fire resistant safe. It is not the intention that all the *custody rules* in the *custody chapter* should be applied to *designated investments* held in the course of settlement.

11. In determining the *client money* requirement under paragraph 6, a *firm* need not include *money* held in accordance with ■ CASS 7.2.8 R (Delivery versus payment transaction).

12. In determining the *client money* requirement under paragraph 6, a *firm*:

(1) should include dividends received and interest earned and allocated;

(2) may deduct outstanding *fees*, calls, rights and interest charges and other amounts owed by the *client* which are due and payable to the *firm* (see ■ CASS 7.2.9 R);

(3) need not include *client money* in the form of *client* entitlements which are not required to be segregated (see ■ CASS 7.4.27 G) nor include *client money* forwarded to the *firm* by its appointed representatives, *tied agents*, field representatives and other agents, but not received (see ■ CASS 7.4.24 G);

(4) should take into account any *client money* arising from ■ CASS 7.6.13 R (Reconciliation discrepancies); and

(5) should include any unallocated *client money*.

Equity balance

13. A *firm's* equity balance, whether with an exchange, *intermediate broker* or OTC counterparty, is the amount which the *firm* would be liable to pay to the exchange, *intermediate broker* or OTC counterparty (or vice-versa) in respect of the *firm's margined transactions* if each of the open positions of the *firm's clients* was liquidated at the closing or settlement prices published by the relevant exchange or other appropriate pricing source and the *firm's* account with the exchange, *intermediate broker* or OTC counterparty is closed.

Margined transaction requirement

14. The total *margined transaction* requirement is:

(1) the sum of each of the *client's equity balances* which are positive;

Less

(2) the proportion of any individual negative *client equity balance* which is secured by *approved collateral*; and

(3) the net aggregate of the *firm's* equity balance (negative balances being deducted from positive balances) on transaction accounts for *customers* with exchanges, *clearing houses*, *intermediate brokers* and OTC counterparties.

15. To meet a shortfall that has arisen in respect of the requirement in paragraph 6(1)(b) or 6(2)(b), a *firm* may utilise its own *approved collateral* provided it is held on terms specifying when it is to be realised for the benefit of *clients*, it is clearly identifiable from the *firm's* own property and the relevant terms are evidenced in writing by the *firm*. In addition, the proceeds of the sale of that *collateral* should be paid into a *client bank account*.

16. If a *firm's* total *margined transaction* requirement is negative, the *firm* should treat it as zero for the purposes of calculating its *client money* requirement.

17. The terms '*client equity balance*' and '*firm's* equity balance' in paragraph 13 refer to cash values and do not include non-cash *collateral* or other *designated investments* held in respect of a *margined transaction*.

17A. A *firm* with a *Part 30 exemption order* which also operates an LME bond arrangement for the benefit of US-resident investors, should exclude the *client equity balances* for transactions undertaken on the London Metal Exchange on behalf of those US-resident investors from the calculation of the *margined transaction* requirement.

Reduced client money requirement option

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18.

(1) When, in respect of a *client*, there is a positive individual *client* balance and a negative *client equity balance*, a *firm* may offset the credit against the debit and hence have a reduced individual *client* balance in paragraph 7 for that *client*.

(2) When, in respect of a *client*, there is a negative individual *client* balance and a positive *client equity balance*, a firm may offset the credit against the debit and hence have a reduced *client equity balance* in paragraph 14 for that *client*.

19. The effect of paragraph 18 is to allow a *firm* to offset, on a *client* by *client* basis, a negative amount with a positive amount arising out of the calculations in paragraphs 7 and 14, and, by so doing, reduce the amount the *firm* is required to segregate.

Chapter 7A

Client money distribution

7A

7A.1 Application and purpose

Application

7A.1.1 R This chapter (the *client money distribution rules*) applies to a *firm* that holds *client money* which is subject to the *client money rules* when a *primary pooling event* or a *secondary pooling event* occurs.

Purpose

7A.1.2 G The *client money 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*.

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7A.2 Primary pooling events

Failure of the authorised firm: primary pooling event

7A.2.1 G

(1) A *firm* can hold *client money* in a *general client bank account*, a *designated client bank account* or a *designated client fund account*.

(2) A *firm* holds all *client money* in *general client bank accounts* for its *clients* as part of a common pool of *money* so 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.

(3) A *firm* holds *client money* in *designated client bank accounts* or *designated client fund accounts* for those *clients* that requested their *client money* 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.

(4) 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 distribution rules*.

7A.2.2 R

A *primary pooling event* occurs:

(1) on the *failure* of the *firm*;

(2) on the vesting of assets in a *trustee* in accordance with an 'assets *requirement*' imposed under section 48(1)(b) of the *Act*;

(3) on the coming into force of a *requirement* for all *client money* held by the *firm*; or

(4) when the *firm* notifies, or is in breach of its duty to notify, the *FSA*, in accordance with ■ CASS 7.6.16 R (Notification requirements), that it is unable correctly to identify and allocate in its records all valid claims arising as a result of a *secondary pooling event*.

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7A.2.3 R ■ CASS 7A.2.2R (4) does not apply so long as:

(1) the *firm* is taking steps, in consultation with the *FSA*, to establish those records; and

(2) there are reasonable grounds to conclude that the records will be capable of rectification within a reasonable period.

Pooling and distribution

7A.2.4 R 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 7A.2.5 R.

7A.2.5 R (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*.

7A.2.6 G 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*.

Client money received after the failure of the firm

7A.2.7 R *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 7A.2.5 R, shows that *money* is due from the *client* to the *firm* at the time of the *primary pooling event*.

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7A.2.8 G *Client money* received after the *primary pooling event* relating to an unsettled transaction should be used to settle that transaction. Examples of such transactions include:

(1) an equity transaction with a trade date before the date of the *primary pooling event* and a settlement date after the date of the *primary pooling event*; or

(2) a *contingent liability investment* that is 'open' at the time of the *primary pooling event* and is due to settle after the *primary pooling event*.

7A.2.9 R 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 7A.2.7 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.

7A.2.10 G Whenever possible the *firm* should seek to split a *mixed remittance* before the relevant accounts are credited.

7A.2.11 R If both a *primary pooling event* and a *secondary pooling event* occur, the provisions of this section relating to a *primary pooling event* apply.

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7A.3 Secondary pooling events

Failure of a bank, intermediate broker, settlement agent or OTC counterparty: secondary pooling events

7A.3.1 R A *secondary pooling event* occurs on the *failure* of a third party to which *client money* held by the *firm* has been transferred under ■ CASS 7.4.1 R (1) to ■ CASS 7.4.1 R (3) (Depositing client money) or ■ CASS 7.5.2 R (Transfer of client money to a third party).

7A.3.2 R ■ CASS 7A.3.6 R to ■ CASS 7A.3.18 R do not apply if, on the *failure* of the third party, the *firm* repays to its *clients* or pays into a *client bank account*, at an unaffected bank, an amount equal to the amount of *client money* which would have been held if a *shortfall* had not occurred at that third party.

7A.3.3 G When *client money* is transferred to a third party, a *firm* continues to owe fiduciary duties to the *client*. Whether a *firm* is liable for a *shortfall* in *client money* caused by a third party failure will depend on whether it has complied with its duty of care as agent or trustee.

Failure of a bank

7A.3.4 G When a bank *fails* and the *firm* decides not to make good the *shortfall* in the amount of *client money* held at that bank, a *secondary pooling event* will occur in accordance with ■ CASS 7A.3.6 R. The *firm* would be expected to reflect the *shortfall* that arises at the *failed* bank in its records of the entitlement of *clients* and of *money* held with third parties.

7A.3.5 G The *client money distribution rules* seek to ensure that *clients* who have previously specified that they are not willing to accept the risk of the bank that has *failed*, and who therefore requested that their *client money* be placed in a *designated client bank account* at a different bank, should not suffer the loss of the bank that has *failed*.

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Failure of a bank: pooling

7A.3.6 R If a *secondary pooling event* occurs as a result of the *failure* of a bank where one or more *general client bank accounts* are held, then:

(1) in relation to every *general client bank account* of the *firm*, the provisions of ■ CASS 7A.3.8 R, ■ CASS 7A.3.13 R and ■ CASS 7A.3.14 R will apply;

(2) in relation to every *designated client bank account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7A.3.10 R, ■ CASS 7A.3.13 R and ■ CASS 7A.3.14 R will apply;

(3) in relation to each *designated client fund account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7A.3.11 R, ■ CASS 7A.3.13 R and ■ CASS 7A.3.14 R will apply;

(4) any *money* held at a bank, other than the bank that has *failed*, in *designated client bank accounts*, is not pooled with any other *client money*; and

(5) any *money* held in a *designated client fund account*, no part of which is held by the bank that has *failed*, is not pooled with any other *client money*.

7A.3.7 R If a *secondary pooling event* occurs as a result of the *failure* of a bank where one or more *designated client bank accounts* or *designated client fund accounts* are held, then:

(1) in relation to every *designated client bank account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7A.3.10 R, ■ CASS 7A.3.13 R and ■ CASS 7A.3.14 R will apply; and

(2) in relation to each *designated client fund account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7A.3.11 R, ■ CASS 7A.3.13 R and ■ CASS 7A.3.14 R will apply.

7A.3.8 R *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;

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(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), and where relevant ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance).

7A.3.9 G 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.

7A.3.10 R For each *client* with a *designated client bank account* held at the *failed* bank:

(1) any *shortfall* in *client money* held, or which should have been held, in *designated client bank accounts* that has arisen as a result of the *failure*, must be borne by all the *clients* whose *client money* is held in a *designated client bank account* of the *firm* at the *failed* bank, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each of the relevant *clients* by the *firm*, 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), and where relevant ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance).

7A.3.11 R *Money* held in each *designated client fund account* with the *failed bank* must be treated as pooled with any other *designated client fund accounts* of the *firm* which contain part of the same designated fund and:

(1) any *shortfall* in *client money* held, or which should have been held, in *designated client fund accounts* that has arisen as a result of the *failure*, must be borne by each of the *clients* whose *client money* is held in that designated fund, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each *client* by the *firm*, in accordance with (1), and the *firm's* records must be amended to reflect the reduced *client money* entitlement;

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(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), and where relevant ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance).

7A.3.12 R A *client* whose *money* was held, or which should have been held, in a *designated client bank account* with a bank that has *failed* is not entitled to claim in respect of that *money* against any other *client bank account* or *client transaction account* of the *firm*.

Client money received after the failure of a bank

7A.3.13 R *Client money* received by the *firm* after the failure of a bank, that would otherwise have been paid into a *client bank account* at that bank:

(1) must not be transferred to the *failed* bank unless specifically instructed by the *client* in order to settle an obligation of that *client* to the *failed* bank; and

(2) must be, subject to (1), placed in a separate *client bank account* that has been opened after the *secondary pooling event* and either:

(a) on the written instruction of the *client*, transferred to a bank other than the one that has *failed*; or

(b) returned to the *client* as soon as possible.

7A.3.14 R If a *firm* receives a *mixed remittance* after the *secondary pooling event* which consists of *client money* that would have been paid into a *general client bank account*, a *designated client bank account* or a *designated client fund account* maintained at the bank that has *failed*, it must:

(1) pay the full sum into a *client bank account* other than one operated at the bank that has *failed*; and

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

7A.3.15 G Whenever possible the *firm* should seek to split a *mixed remittance* before the relevant accounts are credited.

7A

Failure of an intermediate broker, settlement agent or OTC counterparty: Pooling

7A.3.16 R If a *secondary pooling event* occurs as a result of the *failure* of an *intermediate broker, settlement agent* or OTC counterparty, then in relation to every *general client bank account* and *client transaction account* of the *firm*, the provisions of ■ CASS 7A.3.17 R and ■ CASS 7A.3.18 R will apply.

7A.3.17 R *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*, must be borne by all the *clients* whose *client money* is held in either a *general client bank account* or a *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 of (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 intermediate broker, settlement agent* or OTC counterparty 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), and where relevant ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance).

Client money received after the failure of an intermediate broker, settlement agent or OTC counterparty

7A.3.18 R *Client money* received by the *firm* after the *failure* of an *intermediate broker, settlement agent* or OTC counterparty, that would otherwise have been paid into a *client transaction account* at that *intermediate broker, settlement agent* or OTC counterparty:

(1) must not be transferred to the *failed* third party unless specifically instructed by the *client* in order to settle an obligation of that *client* to the *failed intermediate broker, settlement agent* or OTC counterparty; and

(2) must be, subject to (1), placed in a separate *client bank account* that has been opened after the *secondary pooling event* and either:

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(a) on the written instruction of the *client*, transferred to a third party other than the one that has *failed*; or

(b) returned to the *client* as soon as possible.

Notification to the FSA: failure of a bank, intermediate broker, settlement agent or OTC counterparty

7A.3.19 R On the *failure* of a third party with which *money* is held, a *firm* must notify the *FSA*:

(1) as soon as it becomes aware of the *failure* of any bank, *intermediate broker*, *settlement agent*, *OTC* counterparty or other entity with which it has placed, or to which it has passed, *client money*; and

(2) as soon as reasonably practical, whether it intends to make good any *shortfall* that has arisen or may arise and of the amounts involved.

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

ORDINARY APPLICATION

TAKE NOTICE that Steven Anthony Pearson, Anthony Victor Lomas, Michael John Andrew Jervis and Dan Yoram Schwarzmann of PricewaterhouseCoopers LLP, Plumtree Court, London EC4A 4HT, the administrators (the "Administrators") of the above-named company (the "Company") intend to apply to the Companies Court Judge on:

Date:

Time:

Place:

For directions pursuant to paragraph 63 of Schedule B1 and for orders as follows:

1 On the proper construction of CASS:

Identification of the client money pool

Which accounts?

1.1 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?

1.2 Do the answers to question [1.1] above change where the accounts in question are held not in LBIE's name but in the name of a nominee of LBIE?

1.3 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;

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

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

(a) the client bank accounts that LBIE maintained as at 7.56am on 15 September 2008 (the time at which the Administrators were appointed, and which is referred to herein as the "Time of Administration");

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

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

Which sums standing to the credit of one or more of those accounts?

1.5 If the answer to question [1.1(b)], [1.1(c)] and/or [1.1(d)] above is "no", is LBIE obliged to transfer any identifiable client money held by it at the Time of Administration in an account other than a client bank account 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))?

1.6 Is money which was due to LBIE at the Time of Administration and which would, in the ordinary course, have been swept into LBIE's house accounts during the daily reconciliation scheduled for the morning of 15 September 2009 or 16 September 2009, had the administration not intervened, notionally pooled pursuant to CASS 7.9.6R or should it be excluded from the notional pooling?

1.7 If the answer to question [1.6] above is that such money should be excluded from the notional pooling:

(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 client money pool constituted on the notional pooling provided for in CASS 7.9.6R(1) (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 [1.7(a)] 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)?

<u>Holding of pre-administration client money</u>

1.8 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 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 Administration) and the Time of Administration?

1.9 Save as required by the answer to question [1.8] 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 market movements 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 Administration) and the Time of Administration 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?

1.10 Save as required by the answers to questions [1.8] and/or [1.8] 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?

1.11 Is LBIE not now required to adjust the CMP or otherwise 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 Administration which, absent administration, would otherwise have led to an upward adjustment by LBIE of the client money segregated by it?

1.12 In relation to any payments which LBIE is required to make pursuant to the answers to questions [1.8] and/or [1.8] and/or [1.9] and/or [1.11] 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 LBIE obliged to make any payment:

(i) into a client bank account opened by LBIE prior to the time of administration and, if so, whether such money then becomes subject to CASS 7.9.6R(1);

(ii) 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))?

1.13 Is LBIE entitled to recalculate a client's client money entitlement by reference to, or alternatively to take into account in calculating the amount to be distributed to a particular client (i.e. by deducting from the distribution which would otherwise be payable to the client), events occurring since the Time of Administration which, absent administration, would otherwise have led to a downward adjustment by LBIE of the client money segregated by it?

1.14 If the answer to question [1.13] above is "no":

(a) Is a client money entitlement defeasible by reason of events occurring since the Time of Administration?

(b) Can delivery of a security discharge the obligation on LBIE to pay (in whole or in part) a distribution from the CMP?

Calculation of client money entitlements

1.15 Does a client for whom LBIE was required or had agreed to hold client money on a segregated basis have a client money entitlement:

(a) in relation to a position or instrument in respect of which LBIE held money on a segregated basis at the Time of Administration;

(b) in relation to a position or instrument in respect of which LBIE did not hold money on a segregated basis at the Time of Administration.

1.16 Does a client for whom LBIE was neither required nor had agreed to hold client money on a segregated basis have a client money entitlement:

(a) in relation to a position or instrument in respect of which LBIE held money on a segregated basis at the Time of Administration;

(b) in relation to a position or instrument in respect of which LBIE did not hold money on a segregated basis at the Time of Administration.

1.17 Does a client for whom LBIE should have held client money on a segregated basis but did not, and in respect of whom client money is identifiable in LBIE's non-client money accounts, have a client money entitlement in relation to a position or instrument in respect of which LBIE did not hold money on a segregated basis at the Time of Administration.

1.18 Does a client for whom LBIE should have held client money on a segregated basis but did not, and in respect of whom client money is not identifiable in LBIE's non-client money accounts, but for whom LBIE at one time held money in its client money accounts, have a client money entitlement:

(a) in relation to a position or instrument in respect of which LBIE at one time held money on a segregated basis;

(b) in relation to a position or instrument in respect of which LBIE did not at any time hold money on a segregated basis.

1.19 Does a client for whom LBIE should have held client money on a segregated basis but did not, in respect of whom no client money is identifiable in LBIE's non-client money accounts and for whom LBIE at no time held money in its client money accounts, have a client money entitlement?

1.20 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?

1.21 Is LBIE obliged to calculate client money entitlements as at the Time of Administration, and, if not, at what time should client money entitlements be calculated?

1.22 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 Administration?

1.23 How should the client money entitlement be calculated, and, in particular:

(a) 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 Administration and/or subsequently transferred to the CMP as required by the answers to the questions above?

(b) Should a client's 'individual client balance', as referred to in CASS 7.9.7R, be calculated in accordance with paragraphs 7 and 8 of Annex 1 to CASS 7, and, if not, how should it be calculated?

Distribution of CM

1.24 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?

1.25 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 [1.22] 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.

Money held on behalf of affiliates

1.26 Is LBIE obliged under CASS 7 to treat money held for an affiliated company as money held in the course of or in connection with its MiFID business?

1.27 If the answer to question [1.26] is "yes", is LBIE now entitled to rely on the exemption in CASS 7.2.3R in respect of the money that LBIE should have credited (but did not) to an account falling within the description in question [1.1(a)] relation to an affiliated company's positive equity balance with LBIE?

2 The Administrators' costs, fees and expenses of and occasioned by this application be paid:

(a) as an expense of the administration; or

(b) from client money subject of the statutory trust; or

(c) in part as an expense of the administration and in part from client money subject of the statutory trust;

in such proportions as shall be ordered by the Court, and/or that such other order may be made as to the incidence of the Administrators' costs, fees and expenses of this application as the Court thinks fit.

3 That representative respondents be appointed for the purpose of this application pursuant to CPR 19.6, and that provision be made for their costs.

4 Such further order or relief as the Court thinks fit.

Dated this 1 day of May 2009

Linklaters LLP

Solicitors for the Applicant

Address for service: Linklaters LLP, One Silk Street, London, EC2Y 8HQ, Ref: Satindar Dogra/Harriet Ellis

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

ORDINARY APPLICATION

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Third Statement
"SAP3"
1 May 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
STEVEN ANTHONY PEARSON

I, STEVEN ANTHONY PEARSON, of PricewaterhouseCoopers LLP, Plumtree Court, London EC4A 4HT, state as follows.

1 I am a licensed insolvency practitioner and a partner in PricewaterhouseCoopers LLP ("**PwC**"), a firm of accountants at the above address. I am one of the joint administrators of Lehman Brothers International (Europe) ("**LBIE**") (in administration). We were appointed as such by order of Mr Justice Henderson on 15 September 2008.

2 My partners, Anthony Victor Lomas, Michael John Andrew Jervis and Dan Yoram Schwarzmann are the other joint administrators of LBIE (together with me, the "**Administrators**"). I am duly authorised to make this witness statement on behalf of LBIE and the other Administrators.

3 A total of a further 19 Lehman companies have entered into administration in the UK since the date of LBIE's administration. I am a joint administrator of eight of these companies. A list of these companies and the joint administrators (each of whom is a partner in PwC) appointed in respect of each of them appears at pages 1 to 5 of Exhibit SAP3 to this statement.

4 There is now shown to me a paginated bundle of copy documents, marked "SAP3", 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 as one of the Administrators of the Lehman Administration Companies, or they have been provided to me either by my partners and colleagues at PwC involved with the administration of the Lehman Administration Companies, or by the employees of the Lehman Administration Companies who are still available to the Administrators, or by the Administrators' legal advisers, Linklaters LLP.

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

6 I make this statement in support of an application (the "**Application**") for directions seeking clarification of certain of the rules contained in the Client Assets Sourcebook ("**CASS**") issued by the Financial Services Authority (the "**FSA**") relating to client money held by LBIE.

7 LBIE is authorised and regulated by the FSA and as such it is required to comply with CASS, which sets out the FSA's rules on the handling of client money. I am advised that the relevant section of CASS for the purpose of the Application is Chapter 7 'Client money rules'. CASS 7 was recently amended by the FSA, with the changes taking effect on 1 January 2009. References to CASS 7 in this witness statement are to the version of the rules in place as at the time of LBIE's administration, with the corresponding reference to the new rules footnoted where the reference has changed. Copies of both versions of CASS appear at pages 6 to 90 of SAP3.

8 Client money is held on a statutory trust created by CASS 7.7 pursuant to section 139 of the Financial Services and Markets Act 2000. To support the statutory trust, CASS 7.4.11R requires a firm to segregate client money to ensure that it is kept separate from its own house funds. LBIE was accordingly obliged to segregate client money from its own house funds.

9 Certain events (including the administration of a firm) constitute 'primary pooling events' under CASS 7.9.4R[1]. Accordingly, when LBIE was put into administration at 7.56am on 15 September 2008, a primary pooling event occurred. CASS 7.9.6R[2] provides that upon the happening of such an event, client money held in each client money account of the firm is treated as pooled. Money held in those accounts is required by CASS 7.9.6R(2)[3] to be distributed in accordance with CASS 7.7.2R so that each client receives a sum which is rateable to his client money entitlement calculated under CASS 7.9.7R[4].

10 As at the date of administration, the amount of client money segregated by LBIE is believed to be more than USD2.1bn. (The exact figure may turn on the answers to several difficult questions raised by the CASS rules, to which I refer further below.) As LBIE was not a deposit-taking institution, client money was held by LBIE with a number of third party and affiliate banks in a variety of currencies.

11 Since LBIE's administration, the Administrators and their legal advisers have identified a number of legal issues concerning the proper interpretation of LBIE's (and the Administrators') obligations under CASS in relation to the handling of client money, in particular following administration. Certain of these issues were identified in my second witness statement dated 25 February 2009 at paragraphs 107 to 109 and 136.2.

12 I am advised that, following the judgments of Sir Andrew Park[5] and Mr Justice David Richards[6] in Re Global Trader Europe Limited (in liquidation), there is now legal precedent in respect of certain of these issues and the Administrators and their legal advisers are considering the effect of those judgments.

13 The purpose of the Application is to seek directions from the Court in respect of what I shall term "client money issues". The Court's assistance is required because:

13.1 until the Administrators know how to proceed in respect of the issues identified by the directions contained in the draft order, they cannot make even an interim distribution of client monies from the pool to client money creditors; and

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1 7A.2.2R
2 7A.2.4R
3 7A.2.4R(2)
4 7A.2.5R
5 2009 EWHC 602(CH)
6 2009 EWHC 699(CH)

13.2 to the extent that LBIE has an obligation post-administration to top up the pool of client money held at the time of administration, then the client money pool would need to be topped-up with funds from the estate which would otherwise be available for distribution to other creditors. As a result, in addition to being presently unable to calculate how much money is available to client money creditors, the Administrators are presently unable to calculate how much money is available in the general estate for distribution to other creditors.

14 The application is, moreover, urgent. The Administrators are holding a very large amount of money which they wish to return to those entitled to it.

15 The directions sought by the Administrators are set out in the application notice which is exhibited hereto at pages 91 to 99 of Exhibit SAP3 to this statement. Before briefly addressing the scope of the directions set out in that document, I should explain that the Administrators and their advisers are currently working to ensure that they have identified all client money issues the determination of which is necessary before a distribution of the client money held by the Administrators can been made. We will also notify all client money creditors of the scope of the directions proposed to be sought, and invite comments on the same, with a view to ascertaining whether interested parties:

15.1 intend to maintain arguments the determination of which falls outside the scope of the directions in their current form; and/or

15.2 wish to participate in the Application as representative respondents.

16 It may, therefore, in due course become necessary to amend and/or supplement the directions set out in the application notice exhibited to this statement.

17 The directions address the issues set out below. Where I am presently able to do so, I have indicated the potential financial significance of each issue. These figures are, however, provisional estimates only and work is continuing to confirm them and the materiality of those issues in respect of which I do not provide any indication of their potential financial significance. To the extent that any issues do not prove to be sufficiently financially material in order to require directions, then it will be necessary to amend the directions set out in the application notice. It is anticipated that a further witness statement will be filed providing the Court with an update in relation to this work.

17.1 Which accounts the Administrators are required, by CASS 7.9.6R, to pool. CASS 7.9.6R provides "client money held in each client money account of the firm" is to be treated as pooled. "Client money account" is not a defined term. Moreover, the glossary definition of "client bank account" for the purposes of CASS 7 does not clearly explain whether a house account containing client money (which LBIE was required or intended to segregate, but did not) is a client bank account for these purposes. Moreover, there is doubt about whether a client transaction account is a client money account. The determination of these issues may have a significant impact on the size of the client money pool. By way of example, the balances in LBIE's client transaction accounts as at the time of administration were in excess of USD200 million.

17.2 Whether all of the sums standing to the credit of a client money account are required to be pooled. CASS 7.9.6R requires the Administrators to pool *client money* in a client bank account. The Administrators are unclear as to whether money held in client money accounts as at the time of administration which, absent administration, would have been removed from those client money accounts (for example, to reflect payments made by LBIE to clients of their money prior to administration) should not form part of the pool and should instead be available to the general estate. The sums involved here are the subject of ongoing investigation by the Administrators' staff, but they are currently believed to be in excess of USD200 million.

17.3 What the Administrators should do whilst holding the notionally pooled client money (which I shall refer to as the "CMP" (client money pool)) pending distribution of it. There are a number of issues which the Administrators need to consider here, including:

17.3.1 Whether they are required to adjust the CMP to take account of events which happened both before and after the time of administration. This is particularly important because:

(i) of the time which elapsed between when LBIE last adjusted the amounts segregated by it as client money (being the morning of 12 September 2008 but using figures as at close of business on 11 September 2008) and the time of administration. During this time, client money was received and paid out by LBIE and there were market movements

affecting the amount of money which LBIE would have been obliged to segregate as client money in due course, absent administration. The sums involved here are currently estimated to be in the tens of millions of US dollars; and

(ii) the futures and options held by the majority of those clients entitled to receive a distribution from the CMP (whom I shall refer to as the "CMP Clients") in the period after the Administrators were appointed moved against the clients. The Administrators do not want to distribute sums to CMP Clients if they are entitled, on a true construction of CASS, to retain those sums or parts thereof, and should be doing so for the benefit of the general estate.

17.4 Between which clients the Administrators should distribute the CMP (i.e. identifying the CMP Clients). A particular issue here is whether clients for whom LBIE should have segregated money as client money but for whom it did not should nonetheless receive a distribution from the CMP. The potential value of unsegregated claims against the pool is currently estimated to be in excess of USD1 billion. To the extent that unsegregated clients are entitled to receive distributions from the CMP, that may significantly dilute the distributions otherwise available to CMP Clients for whom money was segregated.

17.5 How to quantify the respective entitlements of the CMP Clients. There are a number of issues which the Administrators need to consider here, including the time as at which client money entitlements should be calculated, how client money entitlements in different currencies should be relatively valued and whether a client money entitlement is defeasible by reason of events occurring since the time of administration.

17.6 How to effect the distribution of the CMP between the CMP Clients. The issues here concern in what currency or currencies the Administrators may make distributions from the client money pool and how individual distributions should be calculated.

18 In all of the circumstances, the Administrators respectfully invite the Court:

18.1 in the first instance, to make procedural directions to establish how and when the substantive issues raised by the Application will be determined; and

18.2 thereafter, to make directions pursuant to paragraph 63 of Schedule B1 of the Insolvency Act 1986 in relation to the questions set out in the Ordinary Application Notice.

STATEMENT OF TRUTH

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

Signed: .....

STEVEN ANTHONY PEARSON

1 May 2009