Applicants
A P Clark
First Statement
"APC1"
14 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

FIRST WITNESS STATEMENT OF ANDREW PETER CLARK – REDACTED VERSION OF THE STATEMENT BEFORE MR JUSTICE BLACKBURNE AT A HEARING ON 15 MAY 2009

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

A. INTRODUCTION

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

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

3 A total of a further 19 Lehman companies have entered into administration in the UK since the date of LBIE's administration. 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 APC1 to this statement. These companies, together with LBIE, are referred to in this statement as the "**Lehman Administration Companies**".

4 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. This is my first statement in support of this Application and the second statement in these proceedings.

5 There is now shown to me a paginated bundle of copy documents, marked "APC1", to which I refer in this witness statement. Where no cross reference to the paginated bundle is provided and where there is no other indication of the source of my information or belief, the contents of this witness statement are derived from facts and matters which are within my own knowledge and belief. These facts and matters have been learned either as a result of the work undertaken by me in assisting the Administrators of the Lehman Administration Companies, or they have been provided to me either by the Administrators, my partners and colleagues at PwC involved with the administration of the Lehman Administration Companies, by the employees of the Lehman Administration Companies who are still available to the Administrators, or by the Administrators' legal advisers, Linklaters LLP ("**Linklaters**").

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

7 This statement is divided into 5 sections:

A. Introduction

B. Regulatory Framework and Factual Background

C. Issues on which Directions are Sought

D. Exposition

E. Conclusion

B. REGULATORY FRAMEWORK AND FACTUAL BACKGROUND

8 Paragraphs 7 to 9 of Steven Pearson's first statement in support of this Application (being his third witness statement in these proceedings) briefly summarised certain aspects of the regulatory framework relevant to the Application. In the interests of

clarity, I set out these points again below, together with a more detailed explanation of other relevant aspects of the regulatory framework.

9 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 this Application is Chapter 7 'Client money rules'.

10 Since LBIE's administration, CASS 7 has been amended by the FSA, with the changes taking effect on 1 January 2009. Accordingly, LBIE's obligations arising in relation to client money during the period up to and including 31 December 2008 are governed by the version of CASS then in place (the "**Pre-2009 CASS Rules**") and obligations arising in the period from 1 January 2009 onwards are governed by the version of the rules currently in force (the "**2009 CASS Rules**"). I am advised that the differences between the two versions are not material for the purposes of this Application. Accordingly, references to CASS 7 in this witness statement are to the Pre-2009 CASS Rules, with the corresponding reference in the 2009 CASS Rules footnoted where the reference has changed. Copies of both versions of CASS appear at pages 6 to 90 of APC1.

11 Client money is defined for the purposes of CASS 7 in CASS 7.2.1R[1] as being money that a firm receives from or holds for, or on behalf of, a client in the course of or in connection with business to which CASS applies.[2] Certain exceptions apply, including CASS 7.2.3R which provides that where a client transfers full ownership of money to a firm for the purpose of securing obligations, such money should no longer be regarded as client money. The Administrators intend to issue a separate application for directions relating to certain issues arising in connection with LBIE's reliance on CASS 7.2.3R.

12 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. Segregation can be achieved in either or both

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[1] Now see the Glossary.

[2] Being "MiFID business" under the Pre-2009 CASS Rules, which is in broad terms business of the type covered by the Markets in Financial Instruments Directive (Directive 2004/39/EC of the European Parliament and of the Council) ("**MiFID**"). The directive covers, amongst other matters, most types of dealing in and management of securities and therefore covers most of LBIE's business. The 2009 CASS Rules extend the application of CASS 7 to include *'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'*. Previously this had been covered by CASS 4.

of two ways (as firms are entitled to adopt one approach for some parts of their business and the other approach for other parts[3]):

12.1 the 'normal approach', which involves payment of client money on a payment by payment basis into a segregated client bank account (similar to a solicitor's client trust account) and in due course paying that money directly out of the client bank account; and/or

12.2 the 'alternative approach', under which client money is received into and paid out of a firm's own bank (or 'house') accounts. Money is then segregated as client money by the firm making a single daily reconciling payment to (or withdrawal from) one or more client bank accounts such that the amount held in the latter account(s) (together with relevant amounts credited to any client transaction account) represents the aggregate amount of client money held by the firm.

13 In line with many other large financial institutions, LBIE primarily adopted the alternative approach. Broadly speaking, client money was received by it in various house accounts (or by an affiliate on its behalf), although client money was also paid directly into and out of some of LBIE's client bank accounts. Prior to LBIE entering into administration, each business day, a reconciliation exercise would be performed by LBIE and the amounts segregated by LBIE would be adjusted to reflect movements in client monies. This daily reconciliation exercise would take account of a number of movements including client monies received from or paid out to clients, certain movements in the value of marked to market assets and certain currency movements (in line with LBIE's obligations under CASS 7.4.30R).

14 Under CASS 7.4.30R, client money need not be held by a firm in the same currency as that of receipt, provided that the amount of client money 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 (a "**daily adjustment exercise**").

15 Like many large financial institutions operating in multiple currencies, LBIE often did not hold client money in the same currency as that of receipt. Instead, it segregated client money mainly in US dollars, although some client money, particularly where held with clearing houses, was held in other currencies. This was principally because LBIE regularly handled money in more than 50 different currencies on a

[3] CASS 7.4.19G.

daily basis on behalf of more than 1500 clients across multiple business lines and segregating these sums in the currencies of receipt would have been administratively burdensome. Where LBIE did not hold client money in the currency of receipt (or liability, if different), then, prior to administration at least, LBIE bore the currency risk of fluctuations in the value of such client money deposits in accordance with its obligations under CASS 7.4.30R.

16 CASS 7.4.1R requires a firm to segregate client money "promptly". CASS 7.4.17G indicates that this must be done in any event no later than one business day after receipt by firms adopting the normal approach and, whilst the position is not as clearly stated for firms which adopt the alternative approach, I am advised that the effect of CASS 7.4.18G and paragraph 2 of Annex 1 to CASS 7 appears to be to allow such firms a similar one business day window. LBIE operated on this basis: each business day morning it would calculate and then segregate the amount of client money it should hold based on the client money position as at close of business on the previous working day. Accordingly, when LBIE went into administration at 7.56am on Monday 15 September 2008 (being the "**Time of Administration**"), this reconciliation and segregation exercise had been most recently performed by it on the morning of Friday 12 September 2008, using close of business figures as at Thursday 11 September 2008.

17 In addition to segregating client money in client bank accounts, LBIE would also segregate client money in client transaction accounts. I explain more about these accounts in paragraphs 47 to 58 below.

18 As at close of business each business day, some of the funds sitting in LBIE's house accounts would be swept back to Lehman Brothers Holdings Inc ("**LBHI**"), LBIE's ultimate parent company in the United States. Then, to the extent that the reconciliation and segregation exercise performed each morning by LBIE required it to segregate additional funds as client money, LBHI would provide those funds to LBIE. As a result, some client money paid into LBIE's house accounts would generally be swept back to LBHI each evening, and money in respect of these sums only segregated as client money by LBIE the following morning. Accordingly, as at the Time of Administration, some of the client money received into LBIE's house accounts between close of business on 11 September 2008 and close of business on 12 September 2008 was likely to have been swept back to LBHI, although client money received by LBIE between close of business on 12 September 2008 and the Time of Administration was not.

19 Certain events (including the administration of a firm) constitute 'primary pooling events' under CASS 7.9.4R[4]. Accordingly, at the Time of Administration, a primary pooling event occurred. CASS 7.9.6R[5] 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)[6] 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[7].

20 In addition, upon the occurrence of a primary pooling event, CASS 7.9.9R[8] requires new client bank accounts to be opened to receive all client monies received after the primary pooling event. These monies do not form part of the pool created pursuant to CASS 7.9.6R[9] but are to be returned to the relevant client without delay.

21 Other events (such as the failure of a third party with which client money is held by the firm) constitute 'secondary pooling events' under CASS. These can occur in the absence of a primary pooling event or at or after a primary pooling event. However, where both primary and secondary pooling events occur, then the rules on primary pooling apply (CASS 7.9.13R[10]).

22 As at the date of administration, the amount of client money segregated by LBIE was more than USD2.1 billion. As LBIE was not a deposit-taking institution, this was primarily held by LBIE with a number of third party and affiliate banks. One of these affiliate banks was Lehman Brothers Bankhaus AG ("**Bankhaus**") with whom USD1 billion of client money had been deposited on 12 September for repayment on 15 September 2008. The deposit was not repaid and remains unpaid as at the date of this statement, because on 15 September 2008 Bankhaus was placed under a moratorium imposed by the German regulator, BaFin, and on 12 November 2008 BaFin announced that insolvency proceedings had been commenced in relation to Bankhaus. Bankhaus's failure is likely to mean that there will be a significant shortfall in the client money pool constituted on the notional pooling provided for in CASS 7.9.6R(1)[11] (the "**CMP**").

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4 7A.2.2R

5 7A.2.4R

6 7A.2.4R(2)

7 7A.2.5R

8 7A.2.7R

9 7A.2.4R

10 7A.2.11R

11 7A.2.4R(1)

C. ISSUES ON WHICH DIRECTIONS ARE SOUGHT

23 As noted in Steven Pearson's first witness statement in support of this Application (his third witness statement in these proceedings), since LBIE's administration, the Administrators and their legal advisers have identified a number of legal issues concerning the proper interpretation of the existence and extent of LBIE's obligations under CASS (and the Administrators' obligations in respect thereof) in relation to the handling of client money, in particular following administration. Those issues were set out briefly in paragraphs 17.1 to 17.6 of Steven Pearson's third witness statement and the purpose of this statement is to provide the Court with further details of their context and scope.

24 The reasons why it is important that this Application be brought now were set out in paragraphs 13 and 14 of Steven Pearson's third witness statement.

25 The directions sought by the Administrators are set out in paragraph 26 below.

26 On the proper construction of the FSA's CASS rules:

Identification of the CMP

Which accounts?

26.1 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?

26.2 Do the answers to question 26.1 above change where the accounts in question are held not in LBIE's name but in the name of a nominee of LBIE?

26.3 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)?

26.4 Does the reference to 'client money accounts' in CASS 7.9.6R(1)[12] include:

(a) the client bank accounts that LBIE maintained as at 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?

26.5 If the answer to question 26.1(b), 26.1(c) and/or 26.1(d) and/or 26.1(e) 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))?

26.6 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

[12] 7A.2.4R(1)

2009 or 16 September 2009, had the administration not intervened, notionally pooled pursuant to CASS 7.9.6R[13] or should it be excluded from the notional pooling?

26.7 If the answer to question 26.6 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 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 26.7(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)?

Holding of CMP

26.8 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?

26.9 Save as required by the answer to question 26.8 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

[13] 7A.2.4R

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?

26.10 Save as required by the answers to questions 26.8 and/or 26.9 above, is LBIE not now required to adjust the CMP to take account of any money which, prior to administration, LBIE should already have segregated as client money but had not?

26.11 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?

26.12 In relation to any payments which LBIE is required to make pursuant to the answers to questions 26.8 and/or 26.9 and/or 26.10 and/or 26.11 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)[14];

(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))?

26.13 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

[14] 7A.2.4R(1)

Administration which, absent administration, would otherwise have led to a downward adjustment by LBIE of the client money segregated by it?

26.14 If the answer to question 26.13 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

26.15 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.

26.16 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.

26.17 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.

26.18 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.

26.19 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?

26.20 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?

26.21 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?

26.22 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?

26.23 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[15], be calculated in accordance with paragraphs 7 and 8 of Annex 1 to CASS 7, and, if not, how should it be calculated?

[15] 7A.2.5R

Distribution of client money

26.24 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?

26.25 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 26.22 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

26.26 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?

26.27 If the answer to question 26.26 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 26.1(a) in relation to an affiliated company's positive equity balance with LBIE?

D. EXPOSITION

27 I explain the context in which these directions are sought below. Where possible, I provide indications or estimates of the quantum of the issues referred to below. These indications or estimates are based on the data currently available to the Administrators and their staff. Work is ongoing to seek to verify much of this data and so it is possible that some of the figures and balances set out below will need to be revised. In the event of material revisions, I will file a supplementary witness statement updating the Court.

Identification of the CMP

(I) 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?**

28 CASS 7.9.6R(1)[16] provides that, "if a *primary pooling event* occurs, *client money* held in each *client money* account of the *firm* is treated as pooled." As noted in paragraph 19 above, when LBIE was put into administration at 7.56am on 15 September 2008, a primary pooling event occurred.

29 I am advised that the term "client money account" is not defined in the rules and so an issue arises as to precisely which accounts it includes, and thus which client money falls to be included within the CMP.

30 Whilst the term "client money account" is not defined in the rules, I am advised that the terms "client bank account" and "client transaction account" are defined. Accordingly, on the assumption that the term "client money account" is to be defined by reference to these terms, the Administrators are seeking directions from the Court on what the terms "client bank account" and "client transaction account"

[16] 7A.2.4R(1)

include in the context of LBIE's administration and how the term "client money accounts" may be defined by reference to them.

31 Dealing first with "client bank account", I understand that the term "client bank account" is defined in the Glossary to the FSA's Rules for the purposes of CASS 7 as:

> "(a) an account at a bank which:
>
> (i) holds the money of one or more *clients*;
>
> (ii) is in the name of the *firm*; and
>
> (iii) is a current or deposit account; or
>
> (b) a money market deposit account of *client money* which is identified as being *client money*."

32 I am advised that it is possible that this definition could be interpreted very broadly such that a significant number of the accounts held by LBIE as at the Time of Administration could fall within it. I set out below details of the different types of accounts held by LBIE which the Administrators believe may have contained client money as at the Time of Administration and which could therefore conceivably fall to be categorised as a "client bank account".

33 Prior to administration, in performing its daily reconciliation exercise to calculate how much money should be segregated by it as client money, LBIE's client segregation system ("**CSS**") would look at the balances held across a number of bank accounts and money market deposits, which were used regularly by it in order to deposit segregated client money. The number of these bank accounts/deposits varied over time but in the two year period prior to administration, LBIE used up to 21 such accounts/deposits. I refer to these bank accounts/deposits as LBIE's "core client money bank accounts" and these are the accounts which are intended to be captured in question (I)(a). LBIE would allocate the segregated money held by it outside any client transaction account between these core client money bank accounts, depending on, inter alia, which accounts were paying the most favourable rate of interest and the credit limits LBIE had set for each bank. As at the Time of Administration, four of the core client money bank accounts had credit balances. These four accounts/deposits were held at Bankhaus and three other banks and their respective balances as at the Time of Administration were approximately

USD1 billion, USD500 million, USD 393 million and USD1 million. I explained in paragraph 22 above the difficulties surrounding the return of the Bankhaus deposit.

34 In addition to these core client money bank accounts, the Administrators and their staff have identified more than 275 further accounts (including sub-accounts) which appear to have been designated by LBIE as client cash segregated accounts and which I understand are potentially client bank accounts under CASS. I refer to these accounts as LBIE's "non-core client money bank accounts". These non-core client money bank accounts have been identified by the Administrators and their staff as being potentially client bank accounts by reason of one or more of the following:

34.1 the name of the account noted in LBIE's books and records indicates that the account was intended by LBIE to be a client cash segregated account. For example, "LBIE Segregated Dividends"; and/or

34.2 the Administrators have located a copy of a trust notification letter (being a letter written by LBIE to the bank at which the account was opened notifying the bank that the sums standing to the credit of the account were held on trust for the clients of the same) issued by LBIE pursuant to CASS 7.8.1R (or an equivalent predecessor rule) in respect of the account. The Administrators have so far located copies of 21 such letters (some of which appear to relate to more than one account). An example of such a letter appears at page 91 of Exhibit APC1; and/or

34.3 a review of activity on the account by the Administrators' staff has indicated that the account was intended to be used solely for holding client money.

35 Broadly speaking, these non-core client money bank accounts were all held with a custodian/bank and were used by LBIE in connection with its trading activities.

36 Of the non-core client money bank accounts for which the Administrators have data:

36.1 as at close of business on 12 September 2008, 28 had credit balances totalling in aggregate approximately USD17 million; and

36.2 as at close of business on 15 September 2008, 37 had credit balances totalling in aggregate approximately USD185 million.

In relation to 160 of the remaining non-core client money bank accounts, the Administrators do not currently have details of the balances on these accounts as at these dates since the banks with which those accounts are held have yet to provide the Administrators with that information. However, on the basis of LBIE's books and

records, the Administrators do not currently believe that there will be any material balances on those accounts as at the Time of Administration. In relation to the remainder (for which the Administrators do have details of their balances as at these dates), the Administrators do not believe that these accounts had any material (or any) balances as at the Time of Administration.

37 The Administrators' staff are currently working to identify how much of the USD185 million balance on these accounts was received after the Time of Administration and should therefore be treated as post-administration receipts. In connection with this, an issue has arisen with one client in respect of CHF150 million of this USD185 million balance as to whether this money was received prior to or after the Time of Administration. As the particular issue which concerns this client is believed to concern only that one client, I understand that it is currently proposed that this issue be the subject of separate proceedings.

38 In addition to the accounts described in paragraphs 33 to 37 above, the Administrators have identified more than 440 further accounts (including sub-accounts), which I refer to as LBIE's "house accounts", bringing the total number of accounts (including sub-accounts) maintained by LBIE as at the Time of Administration to more than 700 (not including the core client money bank accounts). On the basis of the information currently available to the Administrators, it is possible that a number of these house accounts contain co-mingled client and house money and the Administrators' staff are working to establish the extent of any such client money. Of the latter house accounts:

38.1 as at close of business on 12 September 2008, 24 had credit balances totalling in aggregate approximately USD162 million; and

38.2 as at close of business on 15 September 2008, 26 had credit balances totalling in aggregate approximately USD297 million.

39 If LBIE's house accounts do contain client money, that will not be surprising. This is because LBIE adopted the alternative approach to segregation of client money (as to which see paragraph 12.2 above). Under the alternative approach, there are no restrictions on client money being paid into a firm's house account - indeed that is the purpose of that approach. Further, as explained in paragraph 16 above, the last adjustment of client money segregated by LBIE was undertaken on the morning of 12 September 2008, using the position as at close of business on 11 September 2008. As a result, to the extent that client money was received by LBIE during the course of 12 September (and was not swept back to the United States in

accordance with the procedure outlined in paragraph 18 above) or was received by LBIE over the course of the weekend of 13/14 September, then it is likely that, as at administration, client money was held by LBIE in a number of its house accounts. It is also possible that some of LBIE's house accounts may contain only client money, although the Administrators have yet to identify any such accounts.

40 I understand that it could be argued that all identifiable client money, wheresoever held, should be pooled under CASS 7.9.6R(1)[17]. In the event that the term "client money account" (whether by reference to the terms "client bank account", "client transaction account" or otherwise) is to be interpreted so as to encompass any account containing money which is identifiably client money, then this would require the Administrators' staff to examine in excess of 10,000 entries across LBIE's house accounts in order to identify any potential client money held in those accounts so that it may be included within the CMP. Whilst the Administrators will in any event be investigating all material deposits which they reasonably believe may be client money and which may therefore constitute trust property (whether or not such money forms part of the CMP), I understand that this exercise would be significantly less extensive. In the event that the Administrators' staff are required to perform the much more extensive exercise of examining thousands of entries across LBIE's house accounts for the purposes of identifying any client money to include in the CMP, then this would be a time-consuming and resource-intensive exercise which would have cost consequences, and likely delay further the distribution of the CMP.

41 The Administrators accordingly seek directions from the Court as to which of LBIE's accounts constitute client bank accounts under CASS.

(II) Do the answers to question (I) above change where the accounts in question are held not in LBIE's name but in the name of a nominee of LBIE?

42 The accounts referred to in paragraphs 33 to 40 above were all held in LBIE's name. However, where LBIE held securities for its clients, some of those securities were held in accounts with custodians and clearing systems in the name of LBPB Nominees Limited ("**LBPBNL**") and Lehman Brothers Nominees Limited ("**LBNL**"), subsidiaries of LBIE's.

43 I understand that, since these securities accounts were held in LBPBNL's and LBNL's names, associated cash accounts (e.g. for the receipt of trade settlements and payments relating to those securities, such as dividends and interest) were also

[17] 7A.2.4R(1)

opened in LBPBNL's and LBNL's names for operational reasons. I shall refer to these accounts as LBIE's "nominee cash accounts". As at the Time of Administration, 26 such accounts (including sub-accounts) were held in LBPBNL's name and two such accounts were held in LBNL's name. LBIE appears to have treated these accounts as client bank accounts and sent trust notification letters in respect of four of them.

44 As at close of business on 12 September 2008, the net balance of the 26 accounts (including sub-accounts) held in LBPBNL's name was USD2.9 million and as at close of business on 15 September 2008, USD52.5 million.

45 As noted in paragraph 31 above, the FSA's definition of the term "client bank account" refers to accounts held in the name of the firm, which these accounts were not. Accordingly, I am advised that there is an issue as to whether these nominee cash accounts should properly be categorised as client bank accounts and/or client money accounts and so whether client money contained in them be treated as pooled under CASS 7.9.6R(1)[18].

46 In the event that they are not, then I understand that the clients to whom the balances on the nominee cash accounts relate may be able to assert a tracing claim in respect of that client money. In that event, those clients would not, at least in respect of that client money, share in any shortfall in the CMP. However, in the event that any clients were not able to assert a tracing claim in respect of their money, then I am advised that those clients would be unsegregated clients, at least in respect of that money. Issues surrounding whether (and, if so, the extent to which) unsegregated clients may have a claim against the CMP are discussed in paragraphs 107 to 121 below.

(III) 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)?**

47 In addition to segregating money in client bank accounts, LBIE also held client money in client transaction accounts. There is however an issue here as to which

[18] 7A.2.4R(1)

transaction accounts maintained by LBIE constitute client transaction accounts. In order to explain this issue, it is necessary briefly to summarise how transaction accounts were used by LBIE.

48 Client transaction accounts are primarily designed to hold margin in respect of derivative transactions for clients, such as futures contracts. In this statement, I refer to such transactions as "margined transactions".

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

50 In relation to such transactions with a client, LBIE was required to segregate as client money each day an amount equivalent to the amount which it would be liable (ignoring any non-cash collateral held) to pay to a client in respect of those transactions if each of the client's open positions was liquidated at the closing or settlement prices published by the relevant exchange or other appropriate pricing source and the client's account closed. So, generally when the markets moved such that the value of a margined transaction for a client increased, LBIE would correspondingly increase the amount of money segregated as client money in respect of that transaction. Equally, when the markets moved such that the value of that margined transaction decreased, the amount of money segregated for that client would be correspondingly adjusted downwards by LBIE. Typically, the amount segregated by LBIE (in addition to any free cash balance) would therefore be equal

to the initial margin paid by the client less any unrealised losses not yet covered by delivery of variation margin or, as the case may be, plus any unrealised gains on the client's position.

51 When a client opened a position with LBIE (a "**Client Position**"), LBIE would in turn open a back-to-back position in the market through the relevant exchange, directly or via an intermediate broker. Where LBIE traded directly then, as a result of the applicable clearing arrangements for that market, this would result in LBIE having a principal to principal position with a clearing house (a "**Market Position**"). LBIE might also have Market Positions with a clearing house from its own proprietary trading unconnected with clients' trading. The clearing house would require margin in order to cover LBIE's obligations to the clearing house under its Market Positions. LBIE would provide that margin either from its own funds or, where it had itself received margin from the client in respect of the Client Position, by passing on some or all of that margin. LBIE did not in practice always call for or receive margin (e.g. from its affiliates). Where it did call for margin from a client, such margin may have been greater than that required by the clearing house. Moreover, the clearing house would assess LBIE's margin requirement based on all of its trades on the relevant account (including where applicable all client trades on that account) whereas LBIE would assess a client's margin requirements based on that client's trades alone. The offsets inherent in the clearing house calling for margin from LBIE on a net basis meant that the net margin required by the clearing house would typically be smaller than the aggregate of the net margins required by LBIE from each of its clients.

52 Whilst LBIE's obligations under a Market Position arising in respect of a Client Position were its own principal obligations just as much as Market Positions arising from LBIE's own account trading positions, some exchanges and their clearing houses accounted separately for positions resulting from trading for clients and positions representing LBIE's own account trading positions. Others did not. For those markets which did account separately, LBIE would have one or more client transaction accounts for Market Positions reflecting Client Positions and one or more (firm) transaction accounts for own account trading. Where LBIE held a client transaction account with that clearing house, the clearing house would credit margin in respect of Market Positions for client trading to that account, since the clearing house would be aware of which of LBIE's positions were client generated and which were proprietary (i.e. where LBIE was trading on its own account). In turn, where LBIE's positions were proprietary, margin provided by LBIE to the

clearing house would be credited by the clearing house to LBIE's house transaction account.

53 Where LBIE held a client transaction account, it was permitted by CASS (under paragraph 14(3) of Annex 1 to CASS 7) and did treat the credit balance in that account as segregated client money for the purposes of its daily reconciliation and segregation exercises.

54 I understand that the term "client transaction account" is defined in the glossary to the rules for the purposes of CASS 7 as:

> "(in relation to a *firm* and an exchange, *clearing house* or *intermediate broker*) an account maintained by the exchange, *clearing house* or *intermediate broker*, as the case may be, in respect of transactions in contingent liability investments undertaken by the *firm* with or for its *clients*."

55 However, as noted above, certain clearing houses and brokers (for example, Eurex Clearing AG ("**Eurex**")) did not offer client transaction accounts. Instead, a single transaction account would be maintained for all trading on LBIE's account (both client generated and proprietary). In these instances, LBIE was not permitted to include the balance on the account in its client money segregation calculation and so any money needing to be segregated as client money was to be segregated in a client bank account. That said, the Administrators are aware of trades being undertaken by LBIE on behalf of some of the underlying clients of one of LBIE's affiliates, Lehman Brothers Inc. ("**LBI**"), where those trades were booked to a house transaction account but no client money in respect of them segregated by LBIE. This and other instances of under-segregation of client money by LBIE are discussed in paragraphs 87 to 93 below.

56 Where LBIE traded via an intermediate broker, its Market Position and its transaction account would be with that broker rather than a clearing house. As with clearing houses, some brokers did and some did not operate separate house and client transaction accounts.

57 I am advised that it is potentially unclear whether single transaction accounts reflecting both client and proprietary trading constitute "client transaction accounts" under CASS.

58 As at the Time of Administration, LBIE was operating client transaction accounts across eight clearing houses and brokers, including its own branch in Korea. These accounts were primarily held at clearing houses. As at close of business on 12

September 2008, these client transaction accounts had credit balances totalling in aggregate approximately USD260 million.

(IV) Does the reference to 'client money accounts' in CASS 7.9.6R(1)[19] 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?**

59 This question has been included to cover the possibility that the term "client money account" is intended to cover accounts other than client bank accounts and client transaction accounts. For example, if the Court holds that an LBIE house account which contained identifiable client money is not a client bank account, but that the term "client money account" encompasses such an account (at least to the extent of the client money contained within it), then the answer to sub-question (c) will determine whether the sums standing to the credit of the account (or alternatively the client money standing to the credit of the account) should form part of the CMP.

(V) If the answer to question (I)(b), (I)(c), (I)(d) and/or (I)(e) 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))?

60 In the event that the term "client bank account" does not include all accounts in which identifiable client money is held and assuming that the effect of this is that (as I understand the wording of CASS 7.9.6R[20] seems to imply) any such identifiable money does not form part of the CMP under CASS 7.9.6R(1)[21], then the Administrators will need to decide what to do with it. If they return any such money to the client for whom it was held, then, in respect of that returned sum at least, that client is likely to be in a better position than those clients whose money does form

[19] 7A.2.4R(1)

[20] 7A.2.4R

[21] 7A.2.4R(1)

part of the CMP, since that client will not be sharing in any shortfall in the CMP (as to the likelihood of which, see paragraph 22 above).

(VI) 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[22] or should it be excluded from the notional pooling?

61 For the reasons explained in paragraph 16 above, when LBIE went into administration at 7.56am on 15 September 2008, it had most recently performed its reconciliation and segregation exercise in respect of client money on the morning of Friday 12 September 2008, using close of business figures as at Thursday 11 September 2008. Accordingly, the amount of money segregated by LBIE as client money as at the Time of Administration did not reflect events which occurred between close of business on 11 September 2008 and the Time of Administration.

62 It appears from the Administrators' investigations to date that a significant amount of money was paid to LBIE's clients (including out of its non-core client money bank accounts) during the course of Friday 12 September and during the course of the weekend. The Administrators' staff are still investigating how much of this money in fact was paid and from which accounts and how much was due to be paid but was not in the event paid, but on the basis of the information currently available to them, it is estimated that at least USD45 million was paid out to LBIE's clients on 12 September 2008.

63 As at the Time of Administration, money continued to be segregated by LBIE as client money in respect of sums which had in fact been paid out and, absent administration, LBIE would in the ordinary course have on the mornings of 15 and 16 September adjusted the money segregated by it in order to reflect the fact that it was no longer holding that money for those clients.

64 In addition to these payments out, events occurred during the course of the same period which, in the ordinary course absent administration, would have required LBIE to adjust the amount of money segregated by it as client money. Since these events would, absent administration, have involved upwards as well as downwards adjustments, I deal with them separately in paragraphs 72 to 86 below.

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[22] 7A.2.4R

65 If 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 2008 or 16 September 2008 had the administration not intervened, is not notionally pooled pursuant to CASS 7.9.6R[23], then I am advised that it should follow that such money would become available to the general estate.

66 I am advised that CASS 7.7.2R sets out for whom and in what order of priority client money held by a firm is held. This 'distribution waterfall' provides that client money is only available to the firm itself once all clients' claims have been met. Given the shortfall in the CMP that is likely to arise for the reasons explained in paragraph 22 above, it is unlikely that all clients' client money claims will be met in full. If that is right, then CASS 7.7.2R would suggest that no money forming part of the CMP may be made available to LBIE in these circumstances.

67 However, I am advised that there is an issue as to when money ceases to be client money under CASS which is relevant to this question. The issue is whether money which has been segregated but which becomes due and payable to a firm ceases to be client money upon becoming due and payable to the firm, or whether it only ceases to be client money once it is removed from segregation. If the position were to be the former, then I understand that at least some of the money segregated by LBIE in respect of these payments would no longer be client money and would instead be available to the general estate.

68 I am also advised that, following the decision of Sir Andrew Park in Re Global Trader Europe Limited (in liquidation), there is now some limited judicial support for such an interpretation.

69 In the circumstances, and in particular having regard to the potential quantum of this issue (as to which see paragraph 62 above), the Administrators seek directions from the Court as to whether such money forms part of the CMP or is available to the general estate.

(VII) If the answer to question (VI) 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:**

[23] 7A.2.4R

(i) **the full amount of the money;**

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

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

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

(b) **is LBIE obliged or permitted to transfer the sum or sums established by the answers to question (VII)(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)?**

70 In the event that 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 2008 or 16 September 2008 had the administration not intervened, is not notionally pooled pursuant to CASS 7.9.6R[24], then an issue arises as to the extent of the amount of that money which may be excluded from the CMP.

71 For the reasons explained in paragraph 22 above, it is currently anticipated that there is likely to be a significant shortfall in the CMP, although the extent of that shortfall is not currently known. In the circumstances, the Administrators would like directions from the Court on the basis of any amount which may be withdrawn from the CMP on account of such sums and confirmation that the amount which may be withdrawn should then become available to the general estate.

Holding of CMP

(VIII) 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?

72 I explained in paragraph 50 above what money LBIE segregated in respect of margined transactions. As I noted there, typically, the amount segregated by LBIE

[24] 7A.2.4R

in respect of such transactions would be equal to the initial margin paid by the client less any unrealised losses not yet covered by delivery of variation margin or, as the case may be, plus any unrealised gains on the client's positions.

73 As set out in paragraph 16 above, when LBIE went into administration at 7.56am on 15 September 2008, it had most recently performed its reconciliation and segregation exercise in respect of client money on the morning of 12 September 2008, using close of business figures as at 11 September 2008.

74 Where LBIE held client transaction accounts, certain fluctuations in the notional value of clients' margined transactions booked with the relevant clearing houses/broker continued to be captured in those accounts during the course of Friday 12 September and subsequently (until those transactions were closed out following administration).

75 In addition, as I noted in paragraphs 52 and 56 above, certain clearing houses and brokers did not operate a separate client transaction account for LBIE's clients, instead operating one shared transaction account for all positions booked by LBIE.

76 Accordingly, (and on the assumption that money in shared transaction accounts does not form part of the CMP), then a significant proportion of fluctuations in the notional values of LBIE's clients' margined transactions during the course of Friday 12 September 2008 (and subsequently on some Asian markets) were not captured in LBIE's client money segregation process prior to the Time of Administration.

77 Whilst the notional values of a number of clients' margined transactions decreased during this period, the notional values of other clients' margined transactions increased. By way of example of the sorts of movements involved, for one client that the Administrators' staff have reviewed, the account balance (i.e. the free cash balance plus the notional value of its margined transactions as at close of business on 11 September 2008) was USD4.3 million. During the course of Friday 12 September 2008, the notional values of those transactions increased in value by USD0.5 million and that client also transferred USD0.7 million of cash to LBIE on Friday 12 September 2008. In aggregate, the total value of clients' account balances for margined transactions decreased in value by nearly USD300 million (i.e. due to changes in free cash balances, margin amounts and market movements) during the course of Friday 12 September 2008. In order to determine the overall value of any adjustment in relation to market movements only that would

be required to the CMP, the Administrators' staff would need to look at over 35,000 movements across more than 2,500 different products for 67 clients.

78 In the event that LBIE were to be required to make such an adjustment to the CMP, the only source of funds for such a payment would be LBIE's general estate.

79 I am advised that this question in relation to adjustments concerning the notional value of margined transactions is being asked separately from question (IX) below (which is concerned with market movements during the same period other than those relating to the margined transactions) since there is some legal precedent in respect of movements relating to margined transactions following the judgment of Sir Andrew Park[25] in Re Global Trader Europe Limited (in liquidation).

(IX) Save as required by the answer to question (VIII) 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?

80 In addition to movements in the notional value of margined transactions in the period between close of business on 11 September 2008 and the Time of Administration, there were a number of other events which would in the ordinary course absent administration have led to an adjustment by LBIE of the amount of money segregated by it as client money. The Administrators have so far identified three different categories of such events (in addition to those relating to margined transactions which are discussed in paragraphs 72 to 79 above), details of which are set out below.

81 Fails

81.1 LBIE regularly entered into trades with its clients, under which a client would agree to trade in certain securities with LBIE at a particular price. If for any reason a trade did not settle (in part) on the due date (i.e. a 'fail' occurred), then LBIE would typically segregate as client money for that client an amount equivalent to all or part of the purchase price (depending on the

[25] 2009 EWHC 602(CH)

extent of the fail) until such time as the fail was fully resolved. This could sometimes result in LBIE segregating as client money amounts not actually required to be so segregated at that time under CASS.

81.2 As at the Time of Administration therefore, a proportion of money segregated by LBIE as client money represented monies segregated in respect of fails, of which a number were resolved (e.g. the securities which had been owing to the clients were fully delivered to them or their accounts) in the period between close of business on 11 September 2008 and the Time of Administration. On the basis of the information currently available to the Administrators, it appears that during the course of Friday 12 September 2008 more than USD2.6 million worth of the USD7.8 million segregated by LBIE in respect of fails as at close of business on 11 September 2008 were resolved. In the ordinary course, LBIE would then have adjusted the amount of money segregated by it as client money in its next reconciliation and segregation exercise to take account of the resolution of these trades. However, since LBIE's last reconciliation and segregation exercise took place using close of business figures as at 11 September 2008, this did not occur prior to administration.

81.3 In addition, new fails were identified during the course of 12 September 2008 which would in the ordinary course have led LBIE to adjust the amount of money segregated by it in its next reconciliation and segregation exercise but which it did not do prior to administration.

82 Depot breaks

82.1 Where LBIE was obliged to hold certain securities on behalf of a client or clients but did not in fact hold a sufficient number in order to meet all clients' requirements (or believed it did not) (a 'depot break'), it would segregate as client money money representing the value of those securities which it ought to have held but did not (or believed it did not). Prior to administration, LBIE would then adjust the amounts segregated by it in respect of such securities both as the value of these securities fluctuated and as sufficient securities were located or delivered to LBIE and segregated for clients.

82.2 As with margined transactions and fails, since LBIE's adjustments of client money were (in accordance with CASS) based on the previous day's close of business figures, as at the Time of Administration, the amount of money segregated in respect of such securities represented the market value of

outstanding (or believed to be outstanding) securities as at close of business on 11 September 2008.

82.3 As at close of business on 11 September 2008, LBIE had segregated in excess of USD216 million in respect of depot breaks. During 12 September 2008, nearly USD138 million worth of these depot breaks were resolved. In addition, the net value of those securities in lieu of which LBIE had segregated money and which had not been resolved decreased by approximately USD390,000. As with fails, in the ordinary course, LBIE would then in its next reconciliation and segregation exercise have adjusted the amount of money segregated by it as client money to take account of the resolution and fluctuation in the value of these depot breaks. However, since LBIE's last reconciliation and segregation exercise took place using close of business figures as at 11 September 2008, this did not occur prior to administration.

82.4 In addition, new depot breaks were identified during the course of 12 September 2008 which would in the ordinary course have led LBIE to adjust the amount of money segregated by it in its next reconciliation and segregation exercise but which it did not do prior to administration.

83 Currency movements

83.1 As noted in paragraph 15 above, LBIE often did not hold client money in the same currency as that of receipt, segregating instead mostly in US dollars. Where it did so, it bore the currency risk of fluctuations in the value of such client money deposits in accordance with its obligations under CASS 7.4.30R. Accordingly, prior to administration, as part of its daily reconciliation and segregation exercise, LBIE would adjust such amounts as it had converted to an amount at least equal to the original currency amount (or the currency in which LBIE had its liability to its clients, if different) translated at the previous day's closing spot exchange rate.

83.2 Since LBIE's adjustments of client money were (in accordance with CASS) based on the previous day's close of business figures, as at the Time of Administration, the amount of money segregated by LBIE had last been adjusted to take account of currency movements as at close of business on 11 September 2008.

84 Accordingly, I am advised that there is an issue as to whether LBIE is obliged to adjust the CMP in order to take account of all of these events and movements between close of business on 11 September 2008 and the Time of Administration.

85 To the extent that LBIE is under an obligation to adjust the CMP and that adjustment requires a payment by LBIE to the CMP, then as with margined transactions, the only source of funds for such a payment would be LBIE's general estate.

86 Conversely, to the extent that any adjustment by LBIE to the CMP would in the ordinary course have been a downwards adjustment, then the issues identified in paragraphs 70 to 71 above in relation to whether LBIE may withdraw monies from the CMP would arise here as well.

(X) Save as required by the answers to questions (VIII) and/or (IX) 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?

87 The Administrators have identified a number of instances in which money which arguably should have been segregated by LBIE in accordance with its obligations under CASS prior to administration was not so segregated. Examples are set out below.

88 Affiliates - margined transactions

88.1 LBIE did not segregate any money in relation to trading in margined transactions with LBI, Lehman Brothers Finance ("**LBF**") and Lehman Brothers Commercial Corporation ("**LBCC**") for their own account. However, LBIE did segregate as client money certain of the monies (but not all - see in this regard paragraph 55 above) arising in relation to such transactions for LBI, where LBI was acting for the account of its underlying customers. As at close of business on 12 September 2008, LBIE had segregated approximately USD101 million as client money for certain of LBI's underlying clients.

88.2 I am advised that there is some doubt as to whether LBIE was required to segregate client money for or on behalf of its affiliates pursuant to CASS. This issue is the subject of questions (XXVI) and (XXVII) below.

88.3

88.4 Accordingly, if LBIE were to be obliged under CASS 7 to segregate all money relating to margined transactions for its affiliates as client money, and it were to be under an obligation now to adjust the CMP to rectify that pre-administration failure to segregate, then this would result in a significant transfer of funds from LBIE's estate to the CMP. In the event that LBIE were not to be under any obligation to adjust the CMP to rectify that pre-administration failure to segregate but the answer to question (XIX) below were to be that wholly unsegregated clients who should have received client money protection have a client money entitlement against the CMP, the effect of that would be to dilute very significantly the distributions made to other client money creditors.

89 Affiliates - intra group financing and other transactions

89.1 LBIE had complex arrangements for the trading of various positions with its affiliates. In connection with this trading, amounts would fall due and payable as between LBIE and the relevant affiliate. Such amounts were credited/debited to the relevant intercompany ledger account (on which payments were made from time to time), as opposed to giving rise to immediate cash movements or the segregation by LBIE of client money.

89.2 I am advised that it is arguable that (under CASS) LBIE should have segregated as client money some or all of the amounts it owed to its affiliates, if those debts were due and payable but had not been paid.

90 Options

90.1 It also appears that LBIE did not generally segregate as client money certain money relating to options transactions with its clients. Whilst LBIE segregated premia received for sold options and variation margin on certain options and gains on options closed-out, it did not otherwise generally segregate for unrealised gains on open options positions. As at 12 September 2008, the approximate aggregate value of these unrealised gains arising from options transactions which had not been not segregated was USD146 million.

91 OTC derivatives

91.1 It appears that LBIE did not segregate any money in respect of over-the-counter ("**OTC**") derivatives because all monies were regarded as being held pursuant to total title transfers in accordance with CASS 7.2.3R. The

Administrators are still investigating the position in relation to such derivatives and so it remains possible that further instances of potential under-segregation may be found.

92 Operational errors

92.1 In addition to those instances where LBIE did not segregate money as client money because it did not believe that it was required to do so, there are also instances where it failed to segregate simply as a result of an operational error. The Administrators are aware of one instance where in excess of USD2 million held by LBIE on behalf of a client was transferred by LBIE to the client's bank in order to be credited by them to the client's account with that bank. However, as a result of an error, this money was transferred back to LBIE's account in mid-August 2008. Following receipt of this transfer of money intended for the client, I am advised that LBIE should either have paid the money to the client or segregated an equivalent amount as client money. It failed to do either, leaving that client unsegregated in respect of that sum.

93 In the event that LBIE were to be required now 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, the only source of funds for such an adjustment would be LBIE's general estate. For the reasons outlined above, then depending on the answer to question (XII) below, the potential quantum of such an adjustment could be significant.

(XI) 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?

94 Questions (VIII) and (IX) above address the issue of what obligations LBIE has to adjust the CMP to take account of events which occurred between close of business on 11 September 2008 and the Time of Administration. The Administrators also require directions on whether LBIE is required to take account of events which have occurred since the Time of Administration.

95 Since administration, the movements identified in questions (VIII) to (IX) above have continued. In respect of margined transactions, all of these transactions have now closed out, giving final actual, as opposed to notional values. In relation to fails, a number of such transactions settled following administration such that the securities owed to those clients have been delivered. In respect of depot breaks, a number of the breaks have been resolved and the values of the underlying securities by reference to which money was segregated by LBIE prior to administration have continued to fluctuate, as have currency values.

96 As would be the case in relation to any obligation to top up the CMP to reflect fluctuations in value prior to the Time of Administration, the only source of funds available to meet any payment due for increases in value since the Time of Administration would be LBIE's estate.

97 I understand that, following the decision of Sir Andrew Park in Re Global Trader Europe Limited (in liquidation), there is now some legal authority to suggest that there is no obligation to continue to adjust the CMP following administration. Nevertheless, the Administrators seek directions from the Court in order to eliminate any doubt on this issue.

(XII) In relation to any payments which LBIE is required to make pursuant to the answers to questions (VIII) and/or (IX) and/or (X) and/or (XI) 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)[26];**

(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))?**

98 The only source of funds for payments due pursuant to any adjustment exercise required following administration would be LBIE's general estate. Accordingly, if following administration LBIE is required to adjust the client money segregated by it

[26] 7A.2.4R(1)

to take account of any of the issues identified in questions (VIII) to (XI) above, the issue arises whether payments due from LBIE in connection with that obligation should be paid as expenses of LBIE's administration in priority to other general creditors or whether the payments should only be paid on a pari passu basis with the claims of other general creditors.

99 If payments were to be paid as expenses of LBIE's administration in priority to other general creditors, then, depending on the extent of any requirement to make a payment, the effect of this could be to elevate client money creditors to a quasi-preferential status following administration (save insofar as there is a shortfall in the CMP for the reasons explained in paragraph 22 above).

100 If following administration LBIE is required to continue to adjust the client money segregated by it then a further issue arises as to whether such top-ups should be paid into a client money account which forms part of the CMP or whether they should be paid directly to the client affected.

101 In the event that such money were to be paid directly to affected clients, then those affected clients would benefit, insofar as such money would not be pooled and would therefore not contribute to reducing any shortfall in the CMP for the benefit of all client money creditors.

(XIII) 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?

(XIV) If the answer to question (XIII) 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?**

102 This question is logically subsequent to those dealing with calculation of a client's client money entitlement, but is addressed here because of the order in which the questions are set out in the Application Notice.

103 Question (XI) above addresses the issue of whether LBIE is required to adjust the CMP by way of a payment to it in order to take account of events which have occurred since the Time of Administration. Questions (XIII) and (XIV) are concerned with the extent to which it is permissible for LBIE to take account of such events which, absent administration, would otherwise have led to a downward adjustment by LBIE of the client money segregated by it and, if it is permissible, how this adjustment should be effected.

104 In relation to this issue, I would like to draw the Court's attention to the following points:

104.1 In relation to margined transactions (which I discuss in further detail at paragraphs 72 to 79 above), as explained above, LBIE would segregate money as client money in relation to such transactions by reference to their notional close-out value on a given date. Since administration, all margined transactions have now been closed out. In respect of some of these margined transactions, their actual close-out values will have been less than their notional values calculated as at the Time of Administration. On the assumption that the answer to question (XXI) below is that LBIE is obliged to calculate client money entitlements as at the Time of Administration (such that the entitlements of margined transaction clients will be determined by reference to their transactions' notional close-out values as at that time as opposed to their subsequent actual close-out values), then some margined transaction clients will have a client money entitlement which is greater than the amount which they would otherwise have received in the absence of LBIE's administration. (Whether or not such clients in fact receive more than they would otherwise have received may depend on the extent of the shortfall in the CMP.)

104.2 In relation to fails (which I discuss in further detail at paragraph 81 above), following administration, some of the trades entered into between LBIE and its clients have settled and the securities owed to those clients were delivered to them (as a result of the automatic settlement process in the relevant clearing and settlement system). Again, on the assumption that the answer to question (XXI) below is that LBIE is obliged to calculate client money entitlements as at the Time of Administration, then, notwithstanding the delivery of securities to these clients following administration, I am advised that these clients will, as at the Time of Administration, have a client

money entitlement. If in due course those clients were to receive a distribution from the CMP in proportion to their client money entitlements, then they would in effect recover twice over (putting to one side for the moment the effect of any shortfall in the CMP) by receiving both the securities and the cash sum segregated by LBIE in respect of its obligation to deliver those securities.

104.3 In relation to depot breaks (which I discuss in further detail at paragraph 82 above), a number of these will have been resolved (in full or in part) following administration and the values of the underlying securities in relation to those that have not have continued to fluctuate. In many cases, the values of these securities will have fallen since the Time of Administration. Where depot breaks have been resolved following administration, then if a client's client money entitlement is to be calculated as at the Time of Administration, then, as with fails in respect of which securities have been delivered following administration, if those clients were to receive a distribution from the CMP in proportion to their client money entitlements, then they would again in effect recover twice over (putting to one side for the moment the effect of any shortfall in the CMP). Where the values of securities as against which LBIE segregated money has fallen, then, if a client's client money entitlement is to be calculated as at the date of administration, (again putting to one side for the moment the effect of any shortfall in the CMP), these clients' distributions may be more valuable than the securities which they would have received had LBIE been holding them instead of segregating money representing their value.

105 In the event that LBIE were to be entitled to recalculate a client's client money entitlement in order to take such events into account, then I understand that the amounts by which any clients' client money entitlements might be reduced as a result of any recalculation could then be made available to other client money creditors, thereby in effect reducing the size of any shortfall in the CMP. If, however, any adjustment were to take place at the point of calculating distributions rather than entitlements, then I am advised that the effect of this would be to make any amounts by which clients' distributions are reduced available to the general estate.

106 In the circumstances, the Administrators are seeking directions from the Court on whether post-administration events may be taken into account and if so, at what stage LBIE may do so.

Calculation of client money entitlements

107 CASS 7.9.6R(2)[27] provides that a "*firm* must distribute...*client money* in accordance with CASS 7.7.2R so that each *client* receives a sum which is rateable to the *client money* entitlement calculated in accordance with CASS 7.9.7R[28]." However, the term "client money entitlement" is not defined in CASS and so I am advised that an issue arises as to which clients have a client money entitlement against the pool.

108 I understand that a number of issues may arise in relation to identifying which clients have an entitlement, depending on what was segregated for that client and how that segregation came about. The possible factual permutations are complex. For example, in respect of a client for whom LBIE should have segregated client money, that client may have (i) nothing segregated for it, (ii) less than should have been segregated for it, (iii) the full amount which should have been segregated for it, or (iv) more than should have been segregated for it. Various points may complicate matters. In respect of unsegregated or under-segregated clients, the amount segregated in respect of those clients as at the Time of Administration may be less than was at one time previously segregated for them as a result of an incorrect withdrawal of client money. In addition, many of LBIE's clients will have held multiple positions in respect of which they were entitled to be segregated but for which they may only have been fully or partly segregated in respect of some of these positions.

109 Questions (XV) to (XX) below are all aimed at addressing these issues.

(XV) 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.**

110 As noted in paragraph 90 above, it appears that LBIE may have failed to segregate as client money money relating to certain options transactions with its clients. However, many of these clients may have had money segregated for them in respect of other positions held with LBIE. In addition, whilst it appears that LBIE did not segregate money on behalf of any of its affiliates in respect of their own

[27] 7A.2.4R(2)

[28] 7A.2.5R

proprietary trading, it may transpire following further investigation that LBIE did in fact segregate some limited client money amounts on behalf of its affiliates, whether inadvertently or otherwise.

111 In the circumstances, the Administrators are seeking directions from the Court on whether, where a client is segregated in respect of certain positions, but not in respect of others, that client has a client money entitlement in respect of all of its positions or only those in respect of which at least some monies were, as at the Time of Administration, segregated by LBIE for that client.

112 In relation to client money which should have been segregated but was not:

112.1 it is possible that such money remains identifiable in LBIE's house accounts. Question (XVII) below is intended to establish the extent to which, if at all, the fact that client money relating to a client is identifiable in LBIE's non-client money accounts affects the issue of whether or not that client has a client money entitlement against the CMP;

112.2 it is possible that money was at one time held on a segregated basis, but was (inappropriately) transferred out of LBIE's client money accounts. Question (XVIII) below is concerned with establishing the extent to which, if at all, the fact that LBIE at one time prior to administration held money on a segregated basis in respect of a client's particular position has any effect on that client's client money entitlement in circumstances where money is no longer so segregated for that client as at the Time of Administration but should have been. Essentially, the question posed is whether the effect of the transfer is to diminish (or to extinguish, if the transfer was in an amount equal to the entirety of the client's client money entitlement) that client's client money entitlement against the CMP, on the basis that LBIE earmarked the withdrawal to a particular contributor;

112.3 question (XIX) below deals with clients for whom money was never held on a segregated basis and in relation to whom client money is not identifiable in one of LBIE's house accounts.

(XVI) 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.**

113 The Administrators are aware of certain instances in which LBIE appears to have segregated money as client money for a client when it was not required to do so. For example, under CASS 7.2.8R, purchase monies received from a client need not be treated as client money in respect of a delivery versus payment transaction through a commercial settlement system where the money will be due to the firm within one business day of the firm delivering the relevant securities to the client, unless that delivery does not in fact occur by close of business on the third business day following the date of the client's payment. However, it appears that LBIE would segregate in respect of delivery versus payment transactions as soon as delivery or payment did not take place on the due date (i.e. a fail occurred). The Administrators do not currently have data available on the potential quantum of what may amount to an over-segregation in respect of fails (in the sense that LBIE may sometimes have segregated monies where it was not yet required to do so by CASS), but the Administrators know that, as at close of business on 11 September 2008, the amount which LBIE had segregated in respect of all fails was USD7.8 million. Accordingly, the quantum in respect of any potential over-segregation in respect of fails could be material.

114 In the circumstances, the Administrators are seeking directions from the Court on whether clients for whom LBIE was not required to segregate money as client money nonetheless have a client money entitlement in respect of such money as was segregated for them. Clearly, in the event (or to the extent) that such clients do not have a client money entitlement then, provided such money remains in the CMP, the effect of this will be to increase the amount of money available to other clients who do have client money entitlements.

(XVII) 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.

115 See paragraph 112.1 above.

(XVIII) 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.**

116 See paragraph 112.2 above.

(XIX) 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?

117 This question is aimed at establishing whether those unsegregated clients for whom money was not held on a segregated basis have a client money entitlement against the CMP.

118 I am advised that following the judgment of Sir Andrew Park in Re Global Trader Europe Limited (in liquidation), there is now legal precedent in respect of this issue which suggests that such clients do not have a client money entitlement against the CMP and I am further advised that this position is consistent with general trust principles.

119 If the effect of the answer to questions (XXVI) and (XXVII) below is that LBIE should have segregated money held for its affiliates as client money, then the most significant category of unsegregated clients is likely to be LBIE's affiliates. As explained in paragraph 87.4 above, in the event that LBIE's affiliates were entitled to claim against the CMP, then the amounts which would otherwise be available to

LBIE's other clients for whom money was segregated by LBIE might be significantly reduced.

120 In the circumstances, the Administrators seek directions from the Court on this issue.

(XX) 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?

121 As noted in paragraph 88.1 above, LBIE did not treat as client money and therefore did not segregate certain monies held for its affiliates. However, LBIE did segregate as client money certain of the monies held for LBI, where LBI was acting for the account of its underlying customers. Accordingly, I am advised that an issue arises as to whether, in these circumstances, LBI should be considered to have a client money entitlement in respect of its own proprietary positions as well as its clients' underlying positions.

(XXI) 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?

122 I am advised that neither CASS 7.9.6R(2)[29] nor 7.9.7R[30] expressly indicate the date as at which clients' client money entitlements should be calculated. For many clients, their client money entitlement will fluctuate from day to day - although the circumstances in which and the extent to which it will fluctuate will depend on what a client's client money entitlement is. Accordingly, in order to value clients' client money entitlements, it is necessary to fix a date and time as at which they should be valued (that date and time being for the purposes of this statement the "**Entitlement Calculation Time**").

123 I am advised that the most obvious choice for the Entitlement Calculation Time would be the Time of Administration and I understand that there is now legal precedent for this following the judgment of Mr Justice David Richards[31] in Re Global Trader Europe Limited (in liquidation).

[29] 7A.2.4R(2)

[30] 7A.2.5R

[31] 2009 EWHC 699(CH)

124 I discuss in paragraphs 72 to 86 and 94 to 106 above the issues which arise from fixing the Entitlement Calculation Time as at the Time of Administration (although I understand that these issues would arise in the event that the Entitlement Calculation Time were to be fixed at any date and time earlier than the date of distribution).

(XXII) 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?

125 As client money entitlements exist (and hence claims against the CMP have been and will be made) in a number of currencies, the Administrators will need to decide on a method to calculate rateable entitlements.

126 I understand that the Administrators consider that the simplest method would be to measure client money entitlements against one another in a common currency. To enable the Administrators to do that, in addition to establishing the Entitlement Calculation Time (from which spot exchange rates for each of the currencies in which claims have been or will be asserted may be taken), they would need to choose a common currency.

127 It would theoretically be possible to calculate rateable entitlements without reference to a common currency. Such an approach would seek to calculate a fixed proportion or percentage that each client should receive of its claim(s). Provided each client received the same proportion of its claim (say, for example, 70%), there would be no need to calculate the relative values of clients' entitlements - for example, a client with an entitlement of USD100 would receive USD70 and a client with an entitlement of GBP100 would receive GBP70. However, this approach would involve a complex mathematical process to calculate the amount to be distributed in respect of each claim and hence (depending on whether payment would be in the currency of the claim – which would require currency conversions to be made – or would simply be made by dividing up the actual currencies held – which would not require currency conversions) either (i) determining how much of which currencies should be retained, and in what amounts certain currencies should be exchanged for other currencies, so as to produce a portfolio of currencies capable of providing each client with the same fixed proportion of its claim(s) or (ii)

determining how much of each of the currencies held each client should receive. Ultimately, however, this would produce a mathematically identical result to the process outlined in paragraph 126 above but would require a much more complex calculation process. I understand that the Administrators and their advisers therefore see no advantage to using this method in preference to the more straightforward method of valuation against a common currency outlined in paragraph 126 above.

128 I am advised that the CASS rules do not state what approach to calculating rateable entitlements should be adopted and so they do not specify against which currency or currencies rateable entitlements may be calculated. In so far as the Court considers it necessary or permissible for the Administrators to calculate entitlements denominated in a single currency rather than entitlements in multiple currencies or percentage shares of the pool, then since the majority of client monies held by LBIE are held in US dollars and a significant number of client claims to be made against the CMP are likely to be in US dollars, it would seem logical for any common currency to be US dollars.

(XXIII) 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[32], be calculated in accordance with paragraphs 7 and 8 of Annex 1 to CASS 7, and, if not, how should it be calculated?**

129 CASS 7.9.6R(2)[33] requires the Administrators to distribute the client money in each client money account of the firm (which money is referred to in the sub-rule in question as "that client money") "in accordance with CASS 7.7.2R, so that each

[32] 7A.2.5R

[33] 7A.2.4R(2)

client receives a sum which is rateable to the *client money* entitlement calculated in accordance with CASS 7.9.7R[34]".

130 I am advised that it is unclear from CASS whether a client's client money entitlement is to be calculated or affected by the amount contained in the CMP in respect of that client, but that the use of the term "that client money" in CASS 7.9.6R(2)[35] may suggest that the claim which each client with a client money entitlement has on the CMP is confined in quantum to the amount of the client money which was in fact segregated for him at the time of the primary pooling event (subject to any adjustment to be carried out in relation to margined transactions provided for in CASS 7.9.7R[36]).

131 The term "client money entitlement" is not defined. Nor does CASS 7.9.7R[37] set out a mechanism or procedure to be followed in calculating a client's client money entitlement. Rather, CASS 7.9.7R[38] simply provides for a setting off between a client's "individual client balance" and the "client equity balance", providing that:

"(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 the *client equity balance* for that *client*."

132 I am advised that the term "individual client balance" is not defined in CASS, although paragraph 7 of Annex 1 to CASS 7 contains a formula in accordance with which "The individual *client* balance for each *client* should be calculated", and paragraph 8 states that LBIE should calculate "the individual *client* balance using the contract value of any *client* purchases or sales."

133 However, these paragraphs appear to set out how a client's individual client balance should be calculated by a firm for the purposes of calculating how much that firm should segregate in respect of that particular client (in the course of its normal business), rather than necessarily how a client's individual client balance should be

[34] 7A.2.5R
[35] 7A.2.4R(2)
[36] 7A.2.5R
[37] 7A.2.5R
[38] 7A.2.5R

calculated for the purposes of CASS 7.9.7R[39] (following a primary pooling event). If and to the extent that the market moves between the last occasion on which a firm carried out the requisite daily reconciliation and the primary pooling event, there will be a discrepancy between the amount calculated in accordance with Annex 1 and the value of a client's position at the time of the pooling event (which situation might be addressed in part in the event that the Court determines, in answer to questions (VIII) and (IX) above, that there is an obligation to top up the CMP by reference to market movements in the notional value of margined transactions, etc, between close of business on 11 September 2008 and the Time of Administration).

134 Whilst not part of the individual client balance calculation set out in paragraphs 7 and 8 of Annex 1, paragraph 12(2) provides that in determining the client money requirement (being the amount which LBIE was required to keep on a segregated basis), a firm "may deduct outstanding *fees*, calls, rights, interest charges and other amounts owed by the *client* which are due and payable to the *firm*". Any deduction made pursuant to this paragraph in conducting the daily reconciliation would necessarily result in a shortfall in the amount held in the CMP to cover aggregate client money entitlements unless, when calculating a client's individual client balance for the purpose of CASS 7.9.7R[40], LBIE is permitted to deduct amounts owed by that client that were due and payable to the firm. The Administrators wish to establish whether LBIE is so entitled. (This issue overlaps to some extent, at least in relation to debts arising by reason of post-administration events, with question (XIII) above.)

135 In the event that:

135.1 money held for LBIE's affiliates should have been treated as client money; and

135.2 clients for whom money should have been held on a segregated basis but was not have a claim against the CMP;

then this issue could be of particular significance in the context of affiliate claims. This is because LBIE's affiliates did not generally, so far as the Administrators are aware, transfer any money to LBIE in order to fund their positions or any margin requirements on the futures and options positions which they held with LBIE.

[39] 7A.2.5R

[40] 7A.2.5R

Instead, money owing to LBIE in respect of these transactions was recorded in intercompany ledgers. In the event that affiliates have a client money entitlement against the CMP, and if LBIE were to be entitled to set off the amount of any unpaid amount against any amount which would otherwise be payable to those affiliates from the CMP, then the amount of money to be received by those affiliates would be significantly reduced, potentially to zero. This would clearly be of benefit both to other (non-affiliate) client money creditors (since it would swell the amount of money in the CMP available to be distributed to them) and to LBIE's general estate (which will be liable for claims by client money creditors in respect of shortfalls in distributions from the CMP).

136 The term "client equity balance" is defined as follows:

> "The amount which a *firm* would be liable (ignoring any non-cash *collateral* held) to pay to a *client* (or the *client* to the *firm*) in respect of his *margined transactions* if each of his open positions was liquidated at the closing or settlement prices published by the relevant exchange or other appropriate pricing source and his account closed. This refers to cash values and does not include non-cash *collateral* or other *designated investments* held in respect of a *margined transaction*."

137 In the circumstances, the Administrators are seeking directions from the Court on this issue.

Distribution of client money

(XXIV) 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?

138 In terms of distribution of the CMP, each client money creditor will have an entitlement in one or more currencies in respect of which a distribution from the CMP is required. The CASS rules are silent on whether, upon distribution, client money creditors are entitled to receive the rateable proportion of their entitlements in the currency or currencies of their original entitlements, or whether they are simply entitled to the equivalent of such amount(s) as at the date of distribution in one or more other currencies.

139 As noted in paragraph 15 above, the majority of client money held by LBIE is held in US dollars. Accordingly, if it were permissible under CASS, it is currently

believed that the simplest and cheapest method of distribution of client money would be to pay all client money creditors in US dollars, regardless of the currency (or currencies) of their entitlements.

140 If, however, LBIE is required to pay client money creditors in the currency (or currencies) of their entitlements, then the Administrators will need to convert some currencies to facilitate this. I understand that it appears that a number of client money creditors' entitlements (and in turn their likely distributions) will be sufficiently small that the costs of converting these distributions into different currencies may not be economic.

(XXV) 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 (XXII) 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.**

141 Once client money creditors' entitlements have been calculated and the amounts of all realisable client money sums are known, the Administrators will need to calculate how much should be distributed to each client money creditor. As the CMP is made up of a variety of currencies, those currencies will need to be valued on a given date. The obvious choice for that date would appear to be the date of distribution, since any earlier date would mean that the value of realisable client monies may change by the date of distribution.

Money held on behalf of affiliates

(XXVI) 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?

142 As noted in paragraph 88.1 above, LBIE did not generally segregate client money for its affiliated companies. However, LBIE did segregate as client money certain of the monies held for LBI, where LBI was acting for the account of its underlying customers.

143 I understand that there is some doubt as to whether LBIE should have segregated money for its affiliates and that a key issue in relation to this concerns whether LBIE

is obliged under CASS 7 to treat money held for an affiliate as money held in the course of or in connection with its MiFID business.

144 I am informed that the reasons for LBIE not segregating money held for its affiliated companies as client money appear to be as follows:

144.1 Prior to 1 November 2007, CASS allowed LBIE not to treat as client money any money held for its affiliated companies. A member of LBIE's compliance department has advised Linklaters that LBIE generally relied on this exemption.

144.2 In relation to the implementation of MiFID and the new client money rules in CASS 7 in November 2007, a member of LBIE's compliance department has advised Linklaters that LBIE understood that, based on certain statements made by the FSA in its policy statement 07/2 ("**PS 07/02**"), the FSA intended to maintain the exemption for monies held for affiliated companies. A copy of the relevant extract of PS 07/2 appears at pages 92 to 100 of Exhibit APC1.

144.3 It therefore appears that LBIE believed that this meant that it could continue not treating monies held for affiliated companies as client money.

145 In the circumstances, the Administrators seek directions from the Court on this issue.

(XXVII) If the answer to question (XXVI) 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 (I)(a) in relation to an affiliated company's positive equity balance with LBIE?

146 As noted in paragraph 11 above, CASS 7.2.3R provides that where a client transfers full ownership of money to a firm for the purpose of securing obligations, such money should no longer be regarded as client money. Accordingly, I am advised that, if LBIE is obliged under CASS 7 to segregate client money for affiliates, then before deciding on whether or not LBIE should actually have segregated all such money as client money, it is necessary to consider whether LBIE may rely on this exemption in order to avoid that consequence.

147 So far as the Administrators are aware, there were no agreements between LBIE and its affiliates under which LBIE's affiliates agreed to transfer to LBIE ownership of its money as collateral in support of its obligations. However, I am advised that CASS 7.2.3R does not require any agreement to have been put in place; it simply

requires a client to have transferred ownership of its money to a firm for the purpose of securing or otherwise covering its obligations.

148 Accordingly, if it can be established that the arrangements between LBIE and its affiliates were such that money (that might otherwise be client money) was not to be segregated by LBIE as such money was to be available to off-set the liabilities incurred by the affiliates to LBIE, then I am advised that CASS 7.2.3R may arguably be relied upon. If so, such money would not need to have been treated as client money and the affiliates would not have claims against the CMP at all.

149 Accordingly, and having regard to the potential adverse consequences of the affiliates having a claim against the CMP, the Administrators are seeking directions from the Court on this issue.

E. CONCLUSION

150 In all of the circumstances, I respectfully invite the Court to make directions pursuant to paragraph 63 of Schedule B1 of the Insolvency Act 1986 in relation to the questions set out in the Application Notice and at paragraph 26 above.

STATEMENT OF TRUTH

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

Signed: .....

ANDREW PETER CLARK

14 May 2009

Applicants
A P Clark
First Statement
"APC1"
14 May 2009

No. 7942 of 2008

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

FIRST WITNESS STATEMENT OF ANDREW PETER CLARK

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