

**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**

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**STATEMENT OF ASSUMED FACTS**

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**1 Introduction**

- 1.1** This statement sets out those facts which the Administrators and the respondents agree<sup>1</sup> can be assumed for the purposes of the Administrators' application for directions as to LBIE's obligations in relation to the handling of client money. The facts set out below are assumed for the purposes only of this application. For the most part, the assumed facts reflect the Administrators' and/or the respondents' current understanding of relevant facts, although in certain instances facts have been assumed where the position is not currently clear<sup>2</sup> or to facilitate representative respondents' appointments in respect of particular issues.<sup>3</sup>
- 1.2** Unless otherwise indicated, capitalised terms used below have the meaning defined in the order of Mr Justice Briggs dated 25 September 2009.

**2 Overview**

- 2.1** Lehman Brothers International (Europe) (in administration) ("**LBIE**") is an unlimited English company. It is one of the companies within the global Lehman Brothers group of companies (the "**Lehman Group**") of which Lehman Brothers Holdings Inc. ("**LBHI**") is the ultimate parent. LBHI is a Delaware corporation.
- 2.2** At the core of the business of the Lehman Group was global investment banking. Until its collapse, it was one of the four biggest investment banks in the United States. It provided financial services to corporations, governments and municipalities, institutional clients and high net worth individuals. The business activities of the Lehman Group were organised in three segments: capital markets, investment banking and investment management. Those

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<sup>1</sup> Unless otherwise indicated.

<sup>2</sup> See, for example, paragraph 2.32 below.

<sup>3</sup> See, for example, paragraphs 4.2, 4.5 and 4.6 below.

segments included businesses in equity and fixed income sales, trading and research, investment banking, asset management, private investment management and private equity. Some or all of these activities were undertaken by several different legal entities within the Lehman Group.

- 2.3** The Lehman Group was headquartered in New York, with regional headquarters in London and Tokyo, and many offices in North America, Europe, the Middle East, Latin America and the Asia-Pacific region.
- 2.4** The principal trading company of the Lehman Group within Europe was LBIE. LBIE's business involved the provision of a wide range of financial services to clients. In addition, LBIE also traded on its own account (termed 'proprietary' trading). LBIE carried out its business globally.
- 2.5** According to internal LBIE papers, LBIE had six divisions:
- 2.5.1** Prime Services: these services were provided across the whole of Europe and in the US and Asia. The Prime Services business involved providing a broad range of services to clients (usually hedge funds). LBIE provided such clients with trade execution, clearing and settlement, custodial and reporting services, entered into over-the-counter ("OTC") derivatives with them, and lent cash and securities to them. Such financing to each hedge fund was usually secured against the assets of the hedge fund that were held by LBIE.
- 2.5.2** Investment Banking: this included European advisory mergers and acquisitions, debt capital markets activities (primarily underwriting income) and equity capital markets activities (including underwriting).
- 2.5.3** Equities: this primarily involved trading with and on behalf of clients but included some proprietary trading. It involved dealing in cash-settled equities, convertibles and equity derivatives, and an equity strategies (event-driven) trading business.
- 2.5.4** Fixed Income: this conducted LBIE's activities with and on behalf of clients in various fixed income instruments, including collateralised debt obligations, credit derivatives, real estate and securitised products.
- 2.5.5** Investment Management: this included personal investment management activities and various private equity investments.
- 2.5.6** Principal Investing: this conducted cross-asset proprietary trading in equities, fixed income and derivatives. All transactions were for the account of LBIE, that is, not undertaken on behalf of clients.
- 2.6** LBIE entered into a number of different agreements with certain of its clients according to the types of services that LBIE provided to them. The agreements that LBIE used included: LBIE's standard terms of business; LBIE's 'title' and 'charge' international prime brokerage

agreements; LBIE's customer account, prime brokerage and margin lending agreements (New York law-governed); LBIE's master institutional futures customer agreement; the ISDA (for OTC derivatives trading); various stock-lending and repurchase agreements; and LBIE's master custody agreement. Under some of these agreements, LBIE expressly agreed to provide client money protection. Under other of these agreements, LBIE sought to rely upon the 'total title collateral transfer' exemption from CASS (as defined in paragraph 2.9 below) to exclude those particular clients from client money protection.

- 2.7** LBIE entered into administration at 7.56am on Monday 15 September 2008 (the "**Time of Appointment**") by way of an administration order made by Mr Justice Henderson on the application of the directors of LBIE.

### **Regulation**

- 2.8** LBIE is authorised and regulated by the Financial Services Authority (the "**FSA**"). It is or was also a member of various exchanges and clearing systems.
- 2.9** LBIE is not authorised by the FSA to take deposits. It was and is, however, permitted to handle client money and so was and remains obliged to comply with the FSA's Client Assets Sourcebook ("**CASS**") when doing so (although the extent of LBIE's obligations following the Time of Appointment is the subject of this application).

### **The alternative approach**

- 2.10** To comply with its obligations under CASS to segregate client money from its own money, LBIE operated what is termed in CASS the alternative approach to segregation.
- 2.11** Under the alternative approach, client money would be paid directly into and out of LBIE's own bank accounts (or an Affiliate's bank accounts) and LBIE would segregate client money by making a single daily reconciling payment to (or withdrawal from) bank accounts used exclusively by LBIE in order to segregate client money. The amount of any such payment would be calculated by LBIE each business day morning based on data as at close of business on the previous business day. The client money segregated by LBIE would then be adjusted accordingly later that day.
- 2.12** In calculating how much money LBIE was required to segregate as client money, LBIE treated balances held on certain accounts held by it with clearing houses and brokers (termed its "**client transaction accounts**", as to which, see paragraph 2.43 below) as segregated. Further details of how LBIE's transaction accounts were operated are set out at paragraphs 2.42 to 2.49 below.
- 2.13** LBIE regularly handled money in more than 50 different currencies on a daily basis on behalf of more than 1500 clients across multiple business lines. As a result, LBIE often did not segregate client money in the same currency as that in which it was received. Instead it segregated client money mainly in US Dollars, although some client money, particularly

where held with clearing houses, was held in other currencies. Prior to administration, where LBIE did not hold client money in the currency of receipt, LBIE bore the currency risk of fluctuations in the value of its client money balances.

- 2.14** As at the Time of Appointment, LBIE had last undertaken a reconciliation and segregation of client money on the morning of 12 September 2008 (the "**Point of Last Segregation**"), using data as at close of business on 11 September 2008 ("**COB 11.09.08**").

### **Client money components**

- 2.15** When calculating the amount of client money required to be segregated by it, LBIE generally included a number of items or components. The extent to which LBIE segregated each of these components for its clients normally varied according to any contractual arrangements in place with those clients. For example, where agreements provided that LBIE held money under a "total title transfer" arrangement, LBIE did not segregate money arising under those agreements.<sup>4</sup> Not all of the components segregated by LBIE would have been visible to its clients at the time of segregation (see in this regard, for example, the description of depot breaks in paragraph 2.16.5 below).

- 2.16** The components included in LBIE's calculation of amounts to be segregated were:

**2.16.1** Cash balances: LBIE generally segregated money in respect of cash balances on custody accounts, dividends, redemptions and coupons arising on securities held by LBIE (or by a custodian on behalf of LBIE) for clients who had client money protection.

**2.16.2** Futures: LBIE generally segregated an amount equal to its clients' free cash balances (if any), initial margin and unrealised gains in connection with their exchange-traded futures positions. LBIE also generally segregated premiums paid by clients in respect of their exchange-traded options positions.

**2.16.3** Margin excess/margin: For certain other (but not all) prime brokerage clients, LBIE segregated an amount equal to those clients' margin requirements. For others (but not all), LBIE segregated money equal to any balances on their prime brokerage accounts in excess of their margin requirement (as determined under the prime brokerage agreement). For some others, LBIE did not segregate any amounts at all under the prime brokerage agreements.

**2.16.4** Stock loan payables: LBIE generally segregated money in respect of stock loan fees, rebates and dividends payable to clients in connection with stock lending business. Fees and rebates were generally segregated on a monthly basis.

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<sup>4</sup> "Title transfer" terms (or the pre-MiFID client money opt-out language) were included as standard in some of LBIE's "precedent" agreements (e.g. in its prime brokerage agreements) and it was for the client to negotiate its amendment or deletion.

- 2.16.5** Depot breaks: LBIE segregated money where it was obliged to hold certain securities on behalf of a client or clients but did not in fact hold a sufficient number of securities to meet all of its clients' requirements (or believed it did not) (a "depot break"). Where a depot break occurred, LBIE would segregate an amount of money representing the value of those securities which it ought to have held but did not (or believed it did not). Money relating to depot breaks was segregated on a stock-line basis, rather than by reference to identified individual clients.<sup>5</sup> This meant that LBIE would calculate how many securities of a particular type it was required to hold for all of its clients in aggregate and how many it was in fact holding. Where shortfalls (or perceived shortfalls) were identified, LBIE would<sup>6</sup> segregate an amount equivalent to the value of the shortfall. The particular client to which the shortfall related (even if it was possible to identify such a client) was not identified by LBIE for the purposes of the client money segregation, since it was assumed that the latter was a temporary measure only until the depot break had been resolved.
- 2.16.6** Fails: Where LBIE entered into a delivery versus payment transaction<sup>7</sup> but insufficient stock was delivered by one party against cash or vice versa<sup>8</sup>, a "partial fail"<sup>9</sup> occurred. Where the failure was on LBIE's side, LBIE would typically segregate as client money for that client an amount equivalent to the value of that part of the securities or purchase price it had not delivered until such time as the fail was fully resolved.
- 2.16.7** Unapplied credits: When credits were posted to LBIE's bank accounts<sup>10</sup>, it was not always possible for LBIE to determine straightaway whether those amounts represented client money which was required to be segregated. These amounts were termed "unapplied credits" and LBIE segregated money in respect of them (pending determination of whether they constituted client money or not).
- (i) In respect of unapplied credits which were between 0 and 3 business days old, LBIE segregated USD104.8 million each day in the period prior to and as at the Time of Appointment. This sum was referred to within LBIE as the

<sup>5</sup> One consequence of this was that money may have been segregated in respect of shares that LBIE should have been holding for clients whom LBIE treated as having contracted out of client money protection in their agreements with LBIE, both from time to time and at the Time of Appointment.

<sup>6</sup> As permitted by CASS 6.5.10R.

<sup>7</sup> A DVP transaction is one in which the buyer's payment for securities is due at the time of delivery of the securities being purchased. Where a DVP transaction is to be settled via a commercial settlement system, delivery of securities and payment are intended to occur broadly simultaneously.

<sup>8</sup> Because, for example, a counterparty from whom LBIE had expected to receive equivalent securities that day had failed to deliver all of the stock.

<sup>9</sup> A "full fail" would occur where neither party complied with any part of their obligations (whether to deliver securities or cash). In these circumstances, there would have been nothing received and held for the client in respect of which LBIE would segregate.

<sup>10</sup> Or debits made to clients' accounts with LBIE where LBIE could not identify a corresponding payment out of its bank accounts to or for the client.

client segregation “buffer”. Its level was based on a formula which had been agreed with the FSA and which would be recalculated annually, by reference to a five week sample period.<sup>11</sup> The level of the buffer was designed to protect those clients to whom LBIE was required to give client money protection. It would be included within the amount segregated by LBIE in its core client money bank accounts each day.

- (ii) In respect of unapplied credits which remained unresolved<sup>12</sup> after 3 business days of being credited to LBIE’s accounts, LBIE would segregate an amount equivalent to those credits. At the Time of Appointment, the total amount segregated in respect of such “3 day plus unapplied credits” was USD53.5 million.

**2.16.8** Manual items: Exceptionally LBIE deemed it necessary to segregate amounts in addition to those that formed part of the daily client money calculation. These would be calculated manually and segregated. At the Time of Appointment, only three items had been segregated manually, the aggregate value of which was less than USD12 million. Money segregated in respect of these items was included within the amount segregated by LBIE in its core client money bank accounts.

**2.17** Segregation of money corresponding to each of the components described above was calculated by LBIE on the basis of the aggregate of individual clients’ entitlements (on a “per account” basis for the majority of components<sup>13</sup>). The amounts locked up by LBIE for futures and options clients did allow for some off-setting between LBIE and its clients - in limited circumstances, liabilities of futures and options clients in connection with their futures and options trading would result in LBIE reducing the amount segregated by it in respect of those clients’ futures positions. However, LBIE did not otherwise operate in accordance with the ‘Reduced client money requirement option’ set out in paragraphs 18 and 19 of Annex 1 to CASS 7. In particular, it did not undertake any form of off-setting as between different components segregated for the same client.

#### **Not all client money was “received” by LBIE**

**2.18** LBIE (or its Affiliates) received some client money from clients or third parties. An example would be a dividend payment paid to LBIE relating to securities held by it for a client. Typically, that money would be received by LBIE (or an Affiliate) by way of a transfer from a

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<sup>11</sup> This would be done by looking at five points during that five week period and calculating the value of all unapplied credits that were less than 3 business days’ old identified by LBIE at those points in time. LBIE would then average these amounts with the average fixing the level of the buffer for the next year.

<sup>12</sup> I.e. as to whether the credits were client money or not.

<sup>13</sup> Although not, for reasons previously explained, for depot breaks or unapplied credits.

third party to one of LBIE's (or an Affiliate's) bank accounts. In such cases, LBIE (or the Affiliate) would receive a credit to one of its bank accounts.<sup>14</sup>

**2.19** However, not all money<sup>15</sup> which was required to be segregated by LBIE was received by way of transfer from clients or third parties. An example of this type of client money would be a "manufactured dividend"<sup>16</sup> due to a client in respect of shares which LBIE had "borrowed" from that client under a stock loan and which LBIE had then sold. In this situation, assuming LBIE was the party required to manufacture the dividend, there would be no "receipt" of any dividend money from a client or third party. Where LBIE gave the client client money protection, LBIE would transfer the relevant amount from its own funds to its core client money bank accounts pursuant to its client money segregation process.<sup>17</sup>

### **LBIE's bank accounts**

**2.20** At the Time of Appointment, LBIE held more than 700 different bank accounts. These accounts were held with banks, including one of LBIE's Affiliates, and broadly fell into one of three categories, being:<sup>18</sup>

**2.20.1** The bank accounts and money market deposits which LBIE used exclusively for segregating client money held by it (outside of any client transaction account).

It was the aggregate balance on these accounts that LBIE would adjust each business day following its reconciliation and segregation exercise. In 1 Clark, these accounts were termed LBIE's "core client bank accounts". At the Time of Appointment, four of these core client money bank accounts had credit balances totalling USD1.9 billion. One of these four accounts (in which LBIE had segregated USD1 billion of client money) was held with Lehman Brothers Bankhaus AG ("**Bankhaus**"). Bankhaus was placed under a moratorium imposed by the German regulator, BaFin, on 15 September 2008; and on 12 November 2008, BaFin announced that insolvency proceedings had been commenced in relation to Bankhaus. It is currently unclear how much, if any, of the money deposited with

<sup>14</sup> The relevant sum (if received by LBIE), together with other amounts, might subsequently be transferred to LBHI as part of the liquidity management process, as to which see paragraph 2.21 onwards below.

<sup>15</sup> LBI wishes to insert the word 'client' in front of 'money. HLBB objects.

<sup>16</sup> A "manufactured dividend" is an amount equal to the dividend paid by the relevant issuer of the shares. It is "manufactured" in the sense that it is an amount equal to the dividend but not the dividend itself. Where LBIE was required to manufacture a dividend, it would pay (if requested by the client) the equivalent amount from its house funds. Absent payment being made and assuming the client received client money protection; LBIE would typically segregate it as client money.

<sup>17</sup> Although on days when the aggregate amount required to be segregated by LBIE as client money was less than the aggregate amount segregated by it on the previous business day, there would be no transfer of funds from LBIE's own accounts to its core client money accounts - only a withdrawal to reduce the aggregate amount of money segregated by LBIE.

<sup>18</sup> This categorisation, and in particular the terms "core client money bank accounts" and "non-core client money bank accounts", has been adopted by the Administrators for the purposes of the Application. Those terms are not contained in CASS and they were not used by LBIE or any of its clients prior to the Time of Appointment.

Bankhaus will be returned to LBIE and for this reason alone, if for no other reason, a significant shortfall in the client money pool<sup>19</sup> is anticipated.

**2.20.2** An intermediate category of accounts which were referred to in 1 Clark as LBIE's "non-core client money bank accounts".

There were more than 300 such accounts of which 37 have been identified as having credit balances as at or around the Time of Appointment. The total of such credit balances at or around the Time of Appointment was over USD175 million. Some of the names or account types by which these accounts were designated in LBIE's books and records appear to designate a client money account and LBIE sent client money trust notification letters in respect of some, but not all, of them. Others appear to have been linked to a securities account holding securities for LBIE's clients maintained by LBIE with a clearing system or custodian. However, in practice LBIE appears to have treated these accounts no differently from its house accounts (as to which see below). In particular, much of the money regularly received into these accounts was not client money<sup>20</sup> and when client money was received into these accounts, LBIE would generally segregate an equivalent amount as client money in its core client money bank accounts.

**2.20.3** LBIE's house accounts.

These accounts (of which there were more than 440, including sub-accounts) contained money which LBIE considered to belong beneficially to it[, as well as any client money received following close of business on 11 September 2008 which had not been transferred to LBHI, as to which see paragraphs 2.21 onwards below]<sup>21</sup>.

Since LBIE operated the alternative approach to segregation (as to which see above), it is likely that some client money was received by LBIE into these accounts between COB on 11.09.08 and the Time of Appointment which was not segregated by LBIE prior to the Time of Appointment. Further, insofar as there are instances where LBIE received client money prior to close of business on 11 September 2008 which it should have segregated but did not, it is possible that LBIE's house accounts still contain that money. Certain of LBIE's house accounts regularly had house and client transactions processed through them. Of these accounts, as at close of business on 12 September 2008, 24 had credit balances totalling in aggregate approximately USD162 million and, as at close of business

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<sup>19</sup> Created pursuant to CASS 7.9.6R.

<sup>20</sup> For example, because it represented proceeds on the sale of securities by LBIE to clients, i.e. money owed to LBIE.

<sup>21</sup> HLBB objects to the words in square brackets, as it considers that it prejudices the issue of whether certain of the sums held in LBIE's house accounts constituted client money.



on 15 September 2008, 26 had credit balances totalling in aggregate approximately USD297 million.

### **Liquidity management process<sup>22</sup>**

- 2.21** LBIE's funding requirements across its many bank accounts would be managed each day as part of a liquidity management process which was intended to assist the Lehman Group to manage its global funding requirements more efficiently, for example, by allowing it to invest surplus funds centrally rather than leave funds in numerous bank accounts potentially earning less interest.
- 2.22** During the course of each business day, funding projections would be prepared estimating what cash would be required by LBIE on the following business day.<sup>23</sup> In other words, an estimate would be made, at an aggregate level, of the anticipated and known payments that LBIE would need to make and that LBIE would receive. If LBIE's payments out were expected to exceed the receipts in, LBIE would obtain additional funding from LBHI (acting through its London branch) to meet the difference. If the receipts in were expected to exceed the payments out, surplus monies would be moved from LBIE to LBHI by debiting LBIE's bank accounts and crediting LBHI's bank accounts. The intercompany ledger account showing balances due between LBIE and LBHI would then be adjusted accordingly.
- 2.23** As well as LBIE's funding needs being determined at an aggregate level, they would also be determined on a bank account by bank account level as part of the liquidity management process. So, where a particular account held by LBIE was expected to have a surplus amount on the next business day, arrangements would be made to move that surplus. Depending on the amount of the anticipated surplus, the credit balance on such an account could be reduced to or near zero. Conversely, where an account was expected to require funding to make payments out, arrangements would either be made to fund that account accordingly, or particular payments otherwise due to be made to third parties from that account might instead be made by LBHI on LBIE's behalf, with the LBIE-LBHI intercompany ledger account being adjusted accordingly.
- 2.24** LBIE's funding requirements to meet its client money segregation obligation under CASS would also be managed as part of the liquidity management process. However, these calculations were performed each business day morning with LBIE segregating the appropriate amount later that same day. As a result, if LBIE required additional funding in

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<sup>22</sup> LBHI objects to the inclusion of paragraphs 2.21 to 2.27 on the grounds of relevance to the application. LBHI also objects to the breadth of the wording, in particular in paragraphs 2.26 and 2.27. No other respondent objects and the paragraphs have therefore been included, although LBHI's objection is noted.

<sup>23</sup> These funding projections would not include an estimated amount in respect of any payment to be made by LBIE the next business day to its segregated accounts, as that calculation would be performed the following business day morning. See further paragraph 2.24 below.

- order to meet any adjustment due to the amounts segregated in its core client money bank accounts, LBIE would seek same day funding from LBHI.
- 2.25** In the months leading up to and as at the Time of Appointment, LBIE was a net debtor of LBHI, such that payments made by LBIE to LBHI as part of the liquidity management process during that time only had the effect of reducing the aggregate amount owed by LBIE to LBHI. Where LBIE needed funding, this increased the amount it owed to LBHI.
- 2.26** All of LBIE's bank accounts were subject to the liquidity management process save that, in relation to LBIE's core client money bank accounts, surplus funds would only be withdrawn from these accounts where LBIE's reconciliation and segregation calculation permitted LBIE to reduce the amount of money segregated by it. Prior to the Time of Appointment therefore, client money first received into one of LBIE's bank accounts was regularly transferred to LBHI's bank account(s) each evening prior to LBIE segregating an equivalent amount the next morning. Given that, it is possible that client money received into LBIE's non-core client money bank accounts or house accounts between COB on 11.09.08 and close of business on 12 September 2008 would have been passed up to LBHI as part of the liquidity management process prior to the Time of Appointment.
- 2.27** Where LBIE's clients paid client money to LBHI instead of LBIE, the LBIE-LBHI intercompany ledger account would be adjusted to reflect the fact that money had been received into LBHI's bank accounts which was for LBIE. However, this would only reduce the amount owed by LBIE to LBHI; no actual cash payment would be received by LBIE in connection with that client money, unless LBIE needed money from LBHI in order to fund its client money segregation payment.

### **Margined transactions**

- 2.28** As noted in paragraph 2.12 above, in addition to segregating client money in its core client money bank accounts, LBIE also treated the balances of its client transaction accounts as being segregated client money. In order to explain more about these and other transaction accounts, it is necessary first to explain how LBIE generally traded in exchange-traded derivative transactions.
- 2.29** Of the derivatives in which LBIE traded, most were margined transactions (i.e. margin was payable in respect of them). In practice, LBIE generally only segregated money in respect of exchange-traded margined transactions. LBIE did not generally segregate in respect of OTC derivatives, on the basis that the majority of OTC derivatives entered into by LBIE with its clients were undertaken pursuant to agreements containing total title transfer-type language. The term "margined transaction" in the context of this application is therefore generally used to mean exchange-traded margined transactions (i.e. futures and options).

- 2.30** In some instances, LBIE traded in margined transactions for its own account<sup>24</sup> (an example of proprietary trading). In other instances LBIE traded with clients.
- 2.31** When LBIE effected a margined transaction with or for a client, LBIE would typically trade in the market in question through the relevant exchange, directly or via an intermediate broker.<sup>25</sup>
- 2.32** In some instances, LBIE effected margined transactions on a principal-to-principal basis. In some other instances, it may have effected margined transactions as agent on behalf of the client.
- 2.32.1** Where LBIE traded as principal, this would give rise to a position in the market and a back-to-back position between LBIE and the client. Typically, a client could enter into a number of margined transactions in the same underlying futures contract, say, which would then be collectively referred to as that client's position in that futures contract (such position, whether in respect of a single or multiple transactions, a "**Client Position**"). Depending on the rules of the exchange and the positions of other LBIE clients at the time of the trade, LBIE's trade in the market would either create a corresponding position in the market exactly matching each Client Position or it would create a market position reflecting the net effect of its Client Positions in the relevant contract (in either such case, a "**Market Position**").
- 2.32.2** Where LBIE traded as agent, there would be no separate, corresponding Client and Market Positions. Here, there would be only in effect the Market Position (or positions) opened by LBIE as agent for its client in the market.
- 2.33** Where LBIE was a member of the relevant exchange and a clearing member of the associated clearing house, LBIE would either:
- 2.33.1** open the Market Position directly with another member of the exchange; that contract would then be novated into two contracts such that LBIE and its original counterpart were each contracting with the clearing house, rather than one another; or
- 2.33.2** the contract would be concluded directly between LBIE and the clearing house so that no novation was necessary.
- 2.34** Where LBIE was not a member of the relevant exchange and clearing house, it would open the Market Position with a broker. That broker would either itself be a member of the relevant exchange and clearing house (and so in turn enter into its own back-to-back position with another exchange member and then the clearing house) or it would in turn

<sup>24</sup> This is of relevance because certain of LBIE's transaction accounts contained money relating to client-generated and proprietary positions. See paragraph 2.46.

<sup>25</sup> In some instances, depending on the rules of the exchange, LBIE might first open a trade with the client and later create a corresponding on-exchange position.

contract with another broker who was a member of the relevant exchange and clearing house (who would then enter into its own back-to-back position, etc.).

- 2.35** In respect of a significant proportion of trading undertaken by LBIE (primarily in the US and Asian markets), LBIE traded with LBI as its broker.

## **Margin**

### ***For Client Positions***

- 2.36** LBIE required its clients to pay deposits to LBIE (known as margin) in connection with futures positions (a type of margined transaction). The client would pay<sup>26</sup> 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 continues until closed out or its maturity date, these are not realised losses<sup>27</sup> and may be reversed by movements favourable to the client in the position prior to it being closed out or its maturity date, as the case may be. 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 ledger account maintained with LBIE). Whilst both initial margin and variation margin covered prospective losses rather than realised losses, variation margin reflected an actual market movement in the position, whereas initial margin merely reflected the future possibility of such a movement.
- 2.37** LBIE's futures clients would typically enter into multiple positions with LBIE and LBIE would only ever call for margin in respect of those transactions on a net basis. In other words, before calling for margin, LBIE would look at all of that client's open positions. Where that client's free cash balance, initial margin and unrealised profits on all of its open positions exceeded its unrealised losses, that client would have what was termed an 'equity excess'.<sup>28</sup> Margin required to be posted (that is, initial margin plus, if appropriate, any variation margin required to be paid by the client) would be deducted from the client's free cash plus unrealised profits and LBIE would only require a client to pay variation margin to the extent that that margin exceeded the client's free cash balance plus unrealised profits.
- 2.38** It may assist to set out a simple example. A client ("A") opens an account, and LBIE requires it to deposit a sum of money up front, typically calculated by reference to the volume of trading which the client was proposing to do. In consequence, A immediately has

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<sup>26</sup> In fact a client would typically open, say, a futures account with LBIE and deposit a sum of money upfront, which LBIE would then use in order to cover that client's margin requirements in respect of the initial transactions to be credited to that account.

<sup>27</sup> Note that some exchanges operate a settlement-to-market system whereby variation margin payments do constitute realised gains or losses.

<sup>28</sup> In respect of those futures and options clients it believed were entitled to client money protection, LBIE typically segregated an amount equivalent to a client's equity excess.

a free cash balance available of, say, USD1 million. A wishes to open a futures position ("P1") which has an initial margin requirement ("IM1") of USD200k. Part of A's free cash balance is used to cover IM1, reducing A's free cash balance to USD800k; the total of A's free cash balance and IM1 is USD1 million. A then opens a second futures position ("P2"), which has an initial margin requirement ("IM2") of USD300k. Again, part of A's free cash balance is used to cover that initial margin. A's free cash balance now falls to USD500k. P2 increases in value to show an unrealised profit of USD 100k. LBIE then credits A's account with the unrealised profit of USD100k. A's equity excess is now USD1.1 million. Of the USD1.1 million, USD500k is free cash. When A wishes to open a third futures position ("P3") with an initial margin requirement ("IM3") of USD750k, A's free cash balance and unrealised profit of USD600k is insufficient to cover IM3. As a result, LBIE would have called for A to make a payment in of at least sufficient cash with which to meet the amount by which IM3 exceeds USD600k, being USD150k.<sup>29</sup>

- 2.39** In respect of certain margined transactions, LBIE was required to segregate as client money 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 that client's positions (e.g. using the example above, USD1.25 million, assuming that A makes the payment required in order to open P3). This would be calculated on the basis that 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.

#### ***For Market Positions***

- 2.40** The clearing house or broker would also require LBIE to pay initial and variation margin in order to cover LBIE's obligations to the clearing house under its Market Positions.
- 2.41** The amounts demanded as margin from LBIE by the clearing houses and brokers would not match what LBIE itself demanded from its clients. The clearing house or broker would only ever require margin on a net basis, taking into account all of LBIE's positions (whether proprietary, or whether relating to underlying positions with its clients or affiliates) held with that clearing house or broker on a particular account. 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.

#### **Transaction accounts**

- 2.42** LBIE held accounts with all of the clearing houses and brokers with which it entered into Market Positions and the clearing houses and brokers would adjust those accounts each business day to take account of new initial or variation margin paid by LBIE and unrealised

<sup>29</sup> GLG and GSIP have suggested this paragraph be deleted, on the basis that it is more commentary than fact. No other respondents have objected.

profits and losses on LBIE's open positions. These accounts have been referred to as "transaction accounts." LBIE's transaction accounts were adjusted on a net basis only. So, as a result of the impact of other trading, a profit (or loss) by LBIE or a particular client would not necessarily result in an increase or decrease in the balance on the transaction account.

- 2.43** Some clearing houses and brokers permitted LBIE to maintain transaction accounts with them which were exclusively used for recording movements (including the payment of margin) relating to client generated positions and against which those clearing houses and brokers agreed they would not exercise rights of set-off relating to LBIE's proprietary positions. Such accounts were treated by LBIE as client transaction accounts. Where such accounts were available, LBIE would also maintain a separate transaction account, which LBIE would use for proprietary or (subject to one exception mentioned in paragraph 2.59 below) Affiliate-generated positions.
- 2.44** At the Time of Appointment, LBIE operated client transaction accounts across 10 different clearing houses and brokers. As at close of business on 12 September 2008, LBIE's client transaction account balances had credit balances totalling in aggregate approximately USD260 million. LBIE treated the balances on its client transaction accounts as segregated for the purposes of its daily reconciliation and segregation exercise. To the extent that the aggregate of the amounts required to be segregated by LBIE as client money in connection with margined transactions exceeded the balances held on LBIE's client transaction accounts, LBIE would segregate the remainder in its core client money bank accounts as part of its daily client segregation calculation.
- 2.45** Where possible, LBIE would have one or more client transaction accounts for Market Positions reflecting Client Positions and one or more house transaction accounts for own-account trading or Affiliate-generated trading.
- 2.46** Where it was not possible for LBIE to maintain client transaction accounts with a clearing house or broker, a single transaction account would be maintained for all trading on LBIE's account (both client-generated and proprietary).
- 2.47** Where LBIE held such co-mingled single transaction accounts, LBIE did not include any part of the balance on these accounts in its client money segregation calculation and any money which LBIE believed needed to be segregated as client money in connection with positions held on these accounts was segregated by LBIE in one or more of its core client money bank accounts. That said, trades were undertaken by LBIE in respect of certain of LBI's underlying clients and booked to a co-mingled or house transaction account but no client money segregated in respect of them.<sup>30</sup> At the Time of Appointment, LBIE operated

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<sup>30</sup> See further paragraph 2.59.4 below.

"co-mingled" and house transaction accounts across 16 different clearing houses and brokers.

- 2.48** Following the Time of Appointment, the balances on all of LBIE's transaction accounts continued to be adjusted by the relevant clearing houses and brokers to take account of changes in the value of the margined transactions (whether client- or Affiliate-generated or proprietary) that were open at the Time of Appointment until those transactions were closed out.
- 2.49** All of the client-generated margined transactions that were open at the Time of Appointment have now been closed out. Between the Time of Appointment and the close-out of these transactions, some of the balances on LBIE's transaction accounts have increased in value, and some have decreased. To date, some clearing houses and brokers have yet to pay some or all of the closing balances on LBIE's transaction accounts to LBIE.

#### **Movements between COB on 11.09.08 and the Time of Appointment**

- 2.50** When LBIE went into administration at 7.56am on 15 September 2008, it had most recently performed its client money reconciliation and segregation exercise on the morning of Friday 12 September 2008 (being the Point of Last Segregation) using data as at COB 11.09.08. As a result, the amount of money segregated by LBIE as client money at the Time of Appointment did not reflect all of the events which had occurred between COB on 11.09.08 and the Time of Appointment. These events included:

- 2.50.1** Cash payments in excess of USD45 million of client money which were paid by LBIE to its clients from its house accounts (or by LBHI on behalf of LBIE). This money represented, for example, free cash balances on client custody accounts and margin excess on prime brokerage accounts and was paid in the ordinary course of LBIE's business.
- 2.50.2** Fluctuations in futures and options clients' net equity balances on margined transactions. During this period, the notional values of some clients' margined transactions increased; that of other clients decreased. At the Point of Last Segregation, LBIE segregated just under USD1.2 billion in respect of clients' net equity excesses on margined transactions (using data as at COB on 11.09.08). Between close of business on 11 and 12 September 2008, there was a net withdrawal of free cash balance by LBIE's segregated futures and options clients of approximately USD274 million, which was paid by LBIE from its house accounts (or by LBHI on behalf of LBIE). In addition, there was a net decrease in the market value of segregated clients' open positions of approximately USD14 million. The net effect of these movements was such that, absent administration, LBIE would on the morning of 15 September 2008 have adjusted the amount segregated by it in respect of futures and options positions downwards from USD1.2 billion to just over

US0.9 billion.<sup>31</sup> Whilst some of this reduction may have been captured in LBIE's client transaction accounts by reference to corresponding fluctuations in the Market Positions opened by LBIE relating to those Client Positions, some of it may not have been captured because LBIE did not hold client transaction accounts on all exchanges.

**2.50.3** The resolution of partial fails in respect of which LBIE had segregated client money, and the occurrence of new partial fails for which nothing was segregated.

- (i) As at the Time of Administration, a proportion of money segregated by LBIE as client money represented monies segregated in respect of partial fails, of which a number were resolved (i.e. the securities which had been owing to the clients were fully delivered to them or their accounts) in the period between COB on 11.09.08 and the Time of Appointment. It appears that during the course of Friday 12 September 2008 more than USD2.6 million out of the USD7.8 million segregated by LBIE in respect of fails as at COB on 11.09.08 were resolved.
- (ii) In addition, new fails were identified during the course of 12 September 2008, in respect of which no money was segregated prior to the Time of Appointment.

**2.50.4** The resolution of depot breaks in respect of which LBIE had segregated client money, and the occurrence of new depot breaks for which nothing was segregated.

- (i) Prior to administration, LBIE would adjust the amounts segregated by it as depot breaks as the value of these securities in respect of which LBIE had segregated money fluctuated and as those depot breaks were resolved.
- (ii) As at COB on 11.09.08, LBIE had segregated in excess of USD216 million in respect of depot breaks. During 12 September 2008, depot breaks worth nearly USD138 million 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.
- (iii) In addition, new depot breaks were identified during the course of 12 September 2008 in respect of which no money was segregated prior to the Time of Appointment.

**2.50.5** Currency movements.

- (i) As noted in paragraph 2.13 above, LBIE did not always hold client money in the same currency as that of receipt or of the liability giving rise to the

<sup>31</sup> Of course, the actual amount of any adjustment by LBIE to the amounts segregated by it would have taken into account all relevant events (i.e. not just those concerning clients' futures and options positions) occurring on 12 September 2008.



obligation to segregate. Instead LBIE segregated mostly in US dollars. Where it did not hold client money in the same currency as that of receipt (or of liability), it bore the currency risk of fluctuations in the value of such client money deposits pursuant to CASS prior to the Time of Appointment. 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.

- (ii) At the Time of Appointment, the balances on LBIE's core client money bank accounts were all held in US dollars but the balances on its client transaction accounts were held in 30 different currencies (in addition to US dollars). Between COB on 11.09.08 and close of business on 12 September 2008, the aggregate value of non-US Dollar denominated currencies segregated by LBIE at the Time of Appointment increased in value against the US Dollar by approximately USD3 million.

### **Movements after the Time of Appointment**

**2.51** Similarly, since the Time of Appointment, LBIE has not adjusted the amounts segregated by it in its core client money bank accounts (although as noted in paragraph 2.48 above, the balances on its transaction accounts (some of which LBIE treated as segregated) continued to be adjusted by the relevant clearing houses and brokers during this period until close-out of all open positions). As a result, the amount of money segregated by LBIE as client money does not reflect all of the events which have occurred since the Time of Appointment. These events include:

- 2.51.1** Continued fluctuations in futures and options clients' net equity balances up to the time of close-out or maturity of those clients' positions. Since all of these positions have now been closed-out or have matured, all client positions now have final actual, as opposed to notional, values.
- 2.51.2** Further resolutions of partial fails in respect of which LBIE had segregated client money.<sup>32</sup>
- 2.51.3** Further resolutions of depot breaks in respect of which LBIE had segregated client money, and the occurrence of new depot breaks for which nothing was segregated. In addition, the values of the underlying securities in respect of those depot breaks which still exist will have continued to fluctuate.

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<sup>32</sup> Although LBIE may not as yet have delivered those securities due to difficulties surrounding the return of clients' assets in the context of its administration.

- 2.51.4** Continued currency movements. Between close of business on 12 September 2008 and 4 September 2009, the aggregate value of the non-US dollar denominated currencies in LBIE's client transaction accounts<sup>33</sup> as against the US dollar increased by approximately USD7 million.
- 2.51.5** In addition to the client money pool being made up of a number of currencies, the relative values of which continue to fluctuate, client money entitlements exist (and hence claims against the client money pool will be made) in a number of currencies, the relative values of which also continue to fluctuate. Until the Administrators know which clients are entitled to claim against the pool, and the permitted extent of their claims, they cannot quantify the value of these movements to date.

### **Potential instances of undersegregation**

- 2.52** The Administrators have identified a number of instances in which it may be said that LBIE should have segregated money in accordance with its obligations under CASS where it did not. Examples are set out below.
- 2.52.1** LBIE did not segregate any money in relation to trading in any transactions, including margined transactions, carried out in respect of Affiliates trading on their own account. The amounts claimed by the Affiliates in connection with this exceed USD3 billion.
- 2.52.2** LBIE did not segregate any money in connection with certain complex arrangements that it had for the trading of various positions with its Affiliates, in connection with which amounts would fall due and payable as between LBIE and those Affiliates but would be posted to the relevant intercompany ledger account rather than always immediately paid.<sup>34</sup>
- 2.52.3** LBIE often entered into agreements with its clients under which LBIE understood that client money protection would not be afforded to various types of money held by it for those clients. Where this was the case, LBIE did not generally segregate money on behalf of such clients. A number of clients with agreements of these types seek to argue that the particular language contained in their agreements was not effective to exclude client money protection, at least not in its entirety. Similarly, where clients entered into a number of agreements with LBIE which provided for differing levels of client money protection, those clients may seek to argue that amounts which were held by LBIE for them at the Time of Appointment were held

<sup>33</sup> The amounts in LBIE's core client money bank accounts were all segregated in US dollars.

<sup>34</sup> This paragraph is intended to capture the RASCALS process which is the subject of a separate application for directions, as well as other transactions such as stock loan agreements and repurchase agreements entered into outside of the RASCALS process. LBI objects to the language used insofar as it describes the RASCALS process. LBI has also commented that, in the absence of specific examples, it is unaware of the additional transactions or arrangements intended to be captured by this paragraph.

pursuant to an agreement which provided for some client money protection as opposed to another which did not.

- 2.52.4** LBIE did not generally segregate as client money certain amounts relating to options transactions with its clients. This was the case for all clients, irrespective of whether they had in place title transfer arrangements with LBIE. Whilst LBIE segregated premiums 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 unrealised gains (not deducting unrealised losses) arising from options transactions which had not been segregated was USD146 million.
- 2.52.5** LBIE did not segregate any money in respect of OTC derivatives because all such money was regarded by LBIE as being held pursuant to total title transfers in accordance with CASS 7.2.3R.
- 2.52.6** From time to time operational errors occurred which led to a failure by LBIE to segregate an appropriate amount for a client.

#### **Potential instances of oversegregation**

**2.53** 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:

- 2.53.1** 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 partial fail occurred), rather than waiting to see whether delivery or payment (whichever was partially outstanding) did in fact occur by close of business on the third business day following the date on which the transaction had been due to settle (as permitted by CASS);
- 2.53.2** LBIE segregated USD104.8 million each day as the client segregation "buffer" in respect of unapplied credits which were between 0 and 3 business days old[, some of which may have been referable to receipts from clients who were not entitled to client money protection]<sup>35</sup>; and
- 2.53.3** at the Time of Appointment, LBIE had segregated USD53.5 million in respect of such "3 day plus unapplied credits", some of which may also have been referable to receipts from clients who were not entitled to client money protection.

<sup>35</sup> HLBB objects to the words in square brackets on the basis that it considers that the amount segregated pursuant to the buffer was not in fact 'referable' to any particular receipts from clients.

**Wrongly de-segregated client**

- 2.54** The Administrators are aware of at least one client for whom LBIE at one time held money on a segregated basis which was transferred out in circumstances where it should have remained segregated for that client. Prior to administration, LBIE had segregated just in excess of USD45,000 in respect of a coupon due to a client. Following segregation, an administrative error led LBIE to believe incorrectly that this coupon amount has been paid to the client. Accordingly, in its next calculation and segregation exercise, LBIE reduced the amount segregated by it in respect of this client. The error was not spotted prior to the Time of Appointment.

**Potential difficulties in pricing open margined transactions as at Time of Appointment**

- 2.55** As at close of business on 12 September 2008, LBIE had approximately 2,100 open positions relating to underlying trading with its clients in futures and options contracts traded across about 47 different exchanges. Of these exchanges, a number (e.g. Eurex and Hong Kong Futures Exchange) were open at the Time of Appointment.
- 2.56** In respect of those exchanges which were open at the Time of Appointment, it is unclear what data will be available to enable the Administrators to value open positions as at the Time of Appointment. In a number of instances, it is possible that there could be no relevant data available. The position could well vary between exchanges. It is also possible that the Administrators will encounter difficulties in establishing what information is available in relation to those exchanges of which LBIE was not a member.
- 2.57** The Administrators do not anticipate significant difficulties in pricing open positions that were traded on exchanges which were closed at the Time of Appointment. The appropriate price in respect of these positions would appear to be the closing settlement price on the previous business day.

**Affiliates**

- 2.58** LBIE did not generally segregate any money as client money for its Affiliates as it did not believe that it was required to do so, by CASS or otherwise.
- 2.59** LBIE did, however, segregate some money relating to futures and options trading undertaken by LBI with LBIE on behalf of certain of LBI's underlying clients.
- 2.59.1** At least as early as April 2008, LBIE indicated that it intended to segregate client money for LBI's underlying futures and options clients. Some emails were subsequently exchanged between LBI and LBIE in relation to LBI futures accounts and the extent to which those accounts contained co-mingled client and "house" (i.e. LBI) positions.
- 2.59.2** On 13 May 2008, LBI wrote a letter to LBIE in which LBI referred to five futures and options accounts held with LBIE and noted that funds deposited on these accounts

belonged to LBI's foreign futures and foreign options commodities customers and should be segregated according to the US Commodities Future Trading Commission Regulations.

- 2.59.3** At a point prior to the Time of Appointment, LBIE began segregating client money in respect of amounts credited to three of these accounts maintained by LBI with LBIE (LBIE RISC account numbers 022-07000, 022-08001 and 022-08002). The balances on these segregated accounts related only to trading undertaken in respect of LBI's clients.
- 2.59.4** Of the two further accounts referred to in LBI's letter, at the Time of Appointment, only one was in credit (LBIE RISC account number 022-08000). The majority of the balance on this account was made up of amounts relating to LBI's proprietary trading, but also included an amount relating to trading undertaken in respect of LBI's clients. LBIE segregated some money in respect of this latter amount. However, nothing was segregated by LBIE in respect of amounts in this account relating to LBI's proprietary trading at the Time of Appointment.

### **3 Paragon Capital Management Fund Limited ("Paragon")**

- 3.1** Paragon held a futures and options account with LBIE. It had closed out all open positions prior to the Time of Appointment and so the balance on its account consisted of a free cash balance only.
- 3.2** Paragon is a Segregated Client for whom the correct amount of client money was segregated as at COB on 11.09.08 and in relation to whom there were no events occurring:
- 3.2.1** between COB on 11.09.08 and the Time of Appointment; or
- 3.2.2** subsequent to the Time of Appointment,
- which would (absent administration) have caused LBIE to adjust the amount of client money segregated for Paragon.
- 3.3** Paragon was not at the Time of Appointment and has not since become a debtor of LBIE.

### **4 GLG Investments plc: GLG European Equity Fund ("GLG")**

- 4.1** GLG held (i) a futures and options account (or accounts) and (ii) a contract for differences account (or accounts) with LBIE.
- 4.2** GLG is a Segregated Client for whom the correct amount of client money was segregated as at COB on 11.09.08.

4.3 GLG's equity excess decreased in value during the period between COB on 11.09.08 and the Time of Appointment as a result of certain amounts of free cash balance being paid out to GLG during that period. As a result, the amount which LBIE (absent administration) would have segregated as client money for GLG at the Time of Appointment would have been less than the amount segregated for GLG at the Point of Last Segregation.

4.4 GLG's open positions decreased in value following the Time of Appointment, such that the amount which LBIE (absent administration) would have been required to segregate as client money for GLG would have further decreased following the Time of Appointment.

4.5 Redacted

4.6

## 5 Goldman Sachs GSIP Master Company (Ireland) Limited ("GSIP")

5.1 GSIP held a futures and options account with LBIE. It held open positions at the Time of Appointment all of which have since closed.

5.2 GSIP is a Segregated Client for whom the correct amount of client money was segregated by LBIE as at COB on 11.09.08.

5.3 In relation to the futures and options business, LBIE received or held client money from GSIP, or from third parties in connection with GSIP's positions, in a number of different currencies. This client money included a large amount of Japanese Yen ("JPY").

5.4 Pursuant to the contractual arrangements between the parties relating to GSIP's margined transactions, LBIE's liability to GSIP was in the currency or currencies in which payments in connection with the specific futures or options contract were denominated. Accordingly, LBIE's contractual liability in respect of transactions in JPY denominated futures contracts (for example) was to be calculated and discharged in JPY.

5.5 JPY has strengthened significantly against the US Dollar since the Time of Appointment and between the Time of Appointment and the close-out of GSIP's margined transactions.

5.6 Since the Time of Appointment, GSIP's positions in exchange-traded margined transactions which it held with or through LBIE that were open at the Time of Appointment increased in value resulting in post-administration gains on such open positions of approximately USD28 million at the time that the relevant transactions closed out. As a result, the amount which LBIE (absent administration) would have segregated as client

money for GSIP in respect of those positions would have been substantially more than the amount segregated for GSIP at the Point of Last Segregation.

- 5.7** LBIE maintained client transaction accounts at all of the clearing houses and brokers with which LBIE carried out exchange-traded margined transactions in connection with GSIP's positions. Whether LBIE acted as agent or principal in respect of GSIP's exchange-traded margined transactions (which is a matter still to be determined), the client transaction accounts were accounts in respect of which the required notifications, instructions and acknowledgements have been given for the purposes of CASS 7.8.2R and, prior to administration, LBIE treated the balances of such accounts as segregated client money.
- 5.8** Since the Time of Appointment, a significant amount of money has been paid into or credited to such client transaction accounts, or ledger entries were made in respect of those client transaction accounts, representing gains on GSIP's positions that remained open as at the Time of Appointment. Since the Time of Appointment, the balances on some of these client transaction accounts have increased and the balances on others have decreased.
- 5.9** No payment of any part of the balances on these particular client transaction accounts has so far been made by the relevant brokers to LBIE .
- 5.10** It is unclear whether any sums representing post-administration gains on Market Positions opened by LBIE in respect of GSIP are specifically identifiable in the hands of the relevant brokers.

## **6 CRC Credit Fund, Ltd ("CRC")**

- 6.1** CRC was a prime brokerage client of LBIE.
- 6.2** CRC is a wholly Unsegregated Client, for whom no client money was segregated by LBIE at the Time of Appointment.
- 6.3** LBIE should have segregated as client money for CRC sums including USD52 million in connection with FX transactions and a cash balance of approximately USD24 million in various currencies on other accounts.

## **7 Claren Road Credit Master Fund Ltd ("Claren Road")**

- 7.1** Claren Road was a prime brokerage client of LBIE.
- 7.2** Claren Road is a wholly Unsegregated Client for whom no client money was segregated by LBIE at the Time of Appointment.
- 7.3** LBIE should have segregated as client money for Claren Road:

- 7.3.1 the sum of about USD8.5 million representing the cash value of a shortfall in assets which should have been held by LBIE on Claren Road's behalf. This shortfall arose on 12 September 2008 and the sum of USD8.5 million would, absent administration, have been segregated by LBIE for Claren Road in respect of this shortfall on the morning of 15 September 2008;
- 7.3.2 such part of the sum of about USD414 million as was owed by LBIE to Claren Road as at 15 September 2008 and which did not constitute cash delivered by Claren Road to LBIE under the terms of a margin lending agreement between Claren Road and LBIE dated 28 December 2005.

## **8 Hong Leong Bank Berhad ("HLBB")**

- 8.1 HLBB was a derivatives counterparty of LBIE.
- 8.2 HLBB has an unsecured claim against LBIE arising out of two derivative trades undertaken pursuant to an ISDA Master Agreement entered into on 28 January 2008 and the related ISDA Credit Support Annex (the "ISDA").
- 8.3 HLBB's claim depends on showing that its settlement liability to LBIE under the two trades is less than the collateral posted by HLBB with LBIE pursuant to the ISDA (which was transferred to LBIE on full title transfer terms such that HLBB lost its proprietary rights in that collateral).

## **9 Lehman Brothers Inc. ("LBI")**

- 9.1 LBI is an Affiliate. LBI is a Delaware corporation. Since 19 September 2008, LBI has been subject to a liquidation proceeding under the US Securities Investor Protection Act 1970, which is being conducted by James W. Giddens as trustee under the supervision of the US Bankruptcy Court.
- 9.2 Prior to the Time of Appointment LBIE held certain money for or on behalf of both LBI and its underlying clients in the course of or in connection with LBIE's business.
- 9.3 The lines of business transacted by LBIE on behalf of LBI were also transacted by LBIE on behalf of entities outside the Lehman Group.
- 9.4 Save insofar as the emails and letter referred to in paragraph 2.59 above may be of relevance, there are no agreements between LBI and LBIE which purport to require a departure from the treatment required by CASS.
- 9.5 There was no material change in LBIE's treatment of money held or received on behalf of LBI following the amendments to CASS introduced in November 2007 in order to implement MiFID.



**9.6** As at close of business on 11.09.08, LBIE had segregated as client money in excess of approximately USD100 million which was referable to certain futures transactions carried out by LBIE in respect of LBI's underlying clients; that is, certain transactions falling within the component of LBIE's alternative approach calculation described at paragraph 2.16.2 above.

**9.7** LBIE did not segregate as client money any other money either for LBI or its underlying clients. In other words, LBIE did not segregate money referable to any of the components of its alternative approach calculation falling within paragraphs 2.16.1 to 2.16.8 above for LBI and its underlying clients, except for those referred to in paragraph 9.6 above. If LBIE was required to segregate such money, the amounts which should have been segregated but which were not are believed by LBI to be very substantial.

## **10 Lehman Brothers Finance AG ("LBF")**

**10.1** LBF is an Affiliate. It is a Swiss company which went into Swiss bankruptcy liquidation on 22 December 2008 at the direction of the Swiss Federal Banking Commission.

**10.2** LBIE has made a claim in the liquidation of LBF but the net indebtedness between the companies (whichever way) has yet to be established.

**10.3** LBF entered into exchange-traded margined transactions with LBIE in respect of which LBIE then entered into Market Positions (the "**ETD Business**"). The ETD Business was carried on from a date before the implementation of CASS 7 (on 1 November 2007) until the Time of Appointment.

**10.4** The ETD Business was done by LBIE because LBIE was a member of the various exchanges upon which the margined transactions were traded, and of the associated clearing houses through which settlement of the trades was made, whereas LBF was not. Yet LBF needed the benefit of the exchange-traded margined transactions in order to hedge its exposure under OTC derivative trades which it had entered into with clients on its own account.

**10.5** The contractual relationship between LBIE and LBF, so far as the ETD Business after 1 November 2007 (and the implementation of CASS 7) was concerned, was governed by LBIE's Post-MiFID Terms and Conditions.

**10.6** The ETD Business ceased upon, and by reason of, LBIE entering into administration.

**10.7** LBIE did not segregate any money as client money for LBF. This is the position in relation to the Outstanding Trades referred to in paragraph 10.8 below.

**10.8** At the Time of Appointment a number of trades had been effected by LBIE as part of the ETD Business which either:

- 10.8.1 had already been closed out, or were deemed by the exchange to be closed out automatically upon LBIE's administration, but in respect of which LBF had yet to receive, by payment from LBIE, the proceeds of the trade (after any process of netting off in respect of outstanding charges, margin requirements or debit balances due in respect of other trades in accordance with LBIE's said Terms and Conditions); or
- 10.8.2 had yet to be closed out and under which the Client Position on the relevant trade therefore remained open both as between LBF and LBIE as well as the corresponding Market Position between LBIE and the relevant clearing house or broker (and in respect of which the open position was not transferred to some other member of the clearing house or broker, in place of LBIE) but which were later closed out with a positive balance being due to LBF (subject to such netting off)
- (together the "**Outstanding Trades**").
- 10.9 LBF asserts that, as a result of the Outstanding Trades, LBIE should have segregated sums as client money for LBF in the region of USD1.3 billion.

## 11 LBHI

- 11.1 LBHI is the ultimate parent of the Lehman Group. LBHI commenced a voluntary case under Chapter 11 of Title 11 of the US Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York on 15 September 2008.
- 11.2 While the exact number is not known, LBHI controls in the region of 2,000 subsidiaries ("**Associated Entities**"). Some of these Associated Entities are solvent.
- 11.3 One Associated Entity controlled by LBHI is known as CMap Fund No. 1 ("**CMAF**"). CMAF is a company limited by shares incorporated under the laws of the Cayman Islands. It was incorporated as a special purpose investment vehicle through which its clients could invest in the underlying securities and instruments held by CMAF and traded in its name.
- 11.4 CMAF entered into a Master Institutional Futures Customer Agreement with LBIE in April 2008 (the "**MIFCA**"). It was an express term of the MIFCA that the value of any cash or property delivered to LBIE should be credited to the trading account in respect of CMAF maintained by LBIE (the "**CMAF Account**") and that LBIE should segregate the net balance of the CMAF Account (including margin) as client monies.
- 11.5 The CMAF Account had a net balance of USD27 million in cash and a margin requirement of USD1 million in relation to open positions immediately prior to the administration of LBIE.
- 11.6 LBIE segregated monies corresponding to the net balance of the CMAF Account (including margin) as client monies. CMAF is therefore a fully segregated client of LBIE.

- 11.7** In addition to the sum segregated for CMAP, LBIE segregated *de minimis* amounts for five other Associated Entities.
- 11.8** Save as is set out above, based on information supplied by the Administrators, LBHI believes that LBIE did not generally segregate client monies for LBHI or its Associated Entities.
- 11.9** LBHI and its Associated Entities also claim to be unsecured creditors of LBIE for very substantial amounts.

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

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**STATEMENT OF ASSUMED FACTS**

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## First supplement to SAF: LBIE's house accounts/receivables

### 1 Cash on LBIE's house accounts

#### 1.1 Bank accounts

- 1.1.1 At paragraph 2.20.3 of the SAF, it is noted that LBIE had more than 440 house bank accounts (including sub-accounts). Certain of these house bank accounts regularly had house and client transactions processed through them. Of the bank accounts referred to in the preceding sentence, at close of business on 12 September 2008, 24 had credit balances totalling approximately USD162 million and as at close of business on 15 September 2008, 26 had credit balances totalling in aggregate USD297 million.
- 1.1.2 Of LBIE's remaining house bank accounts, some had substantial credit balances as at the time of administration. While it appears that all of these accounts were subject to LBIE's liquidity management process, significant credit balances remained on a number of them (often on a relatively long-term basis) for a variety of reasons, including:
- (i) collateral requirements – LBIE was required to hold collateral with various entities in connection with its normal clearing and settlement operations (e.g. with Euroclear);
  - (ii) regulatory requirements – LBIE was required to hold money in some jurisdictions to meet local regulatory requirements in relation to its branches or operational activities in those jurisdictions (e.g. in Korea);
  - (iii) FX restrictions – LBIE also held monies in some jurisdictions where it was not able to convert and repatriate its monies freely (e.g. in Argentina).
- 1.1.3 The accounts referred to in paragraph 1.1.2 were subject to LBIE's liquidity management process because, in calculating its funding requirements each day, LBIE would look at the balances across all of its bank accounts (save for its core client money bank accounts). Where balances on particular bank accounts needed to remain relatively static, the balance noted as being on that account in LBIE's funding projections would simply match the balance noted as being required for the next day on that account.
- 1.1.4 There were also credit balances on some other house bank accounts at the time of administration. These balances would be the result of, for example,

settlement failures, or funds being received following close of business on 12 September 2008 - in effect "operational friction".

- 1.1.5 The Administrators believe that client money may regularly have passed through the accounts referred to in paragraph 1.1.1. They believe that it is less likely that client money would regularly have passed through LBIE's remaining house bank accounts, but they are not in a position to confirm whether it may be said in respect of any of LBIE's house bank accounts that no client money ever passed through them.

## 1.2 Transaction accounts

- 1.2.1 LBIE also held house transaction accounts with substantial balances on them at the time of administration. Where LBIE did not also hold a client transaction account with the relevant clearing house or broker, these house transaction accounts included balances relating to third party client-generated positions. In those circumstances, LBIE posted amounts with the relevant clearing house or broker but also separately segregated an amount in its core client money bank accounts in relation to the client money it believed it needed to hold in respect of those positions in order to comply with CASS.

- 1.2.2 Where LBIE did hold a client transaction account with the relevant clearing house or broker, its house transaction accounts would contain positions resulting from its own proprietary trading, as well as affiliate-generated positions (in respect of which LBIE did not generally segregate any amounts).

- 1.3 In aggregate, at the time of administration the balances across these house bank and transaction accounts totalled (subject to recovery) an amount in the billions of US dollars.

## 2 Receivables

- 2.1 Prior to LBIE's administration, broadly speaking receivables owed to LBIE (for its own account) were generally paid to LBIE where they related to securities and otherwise generally to LBHI.

- 2.2 Since LBIE's administration, receivables relating to:

- 2.2.1 securities held by LBIE in custodian accounts maintained by it prior to administration have generally been paid into the cash accounts LBIE had prior to the time of administration (although where possible they have since been transferred to bank accounts opened by the Administrators' in LBIE's name since administration ("LBIE's post-administration accounts"); and

**2.2.2** securities moved by the Administrators to the new custodian appointed following administration have generally been and continue to be paid to LBIE's post-administration accounts.

**2.3** Subject to paragraph 2.2.1, the Administrators have attempted to ensure that receivables are paid directly to LBIE's post-administration accounts (although, on occasion, payments have still been made to LBHI).

**Second supplement to SAF: Interest earned on pre-administration client money**

Interest was paid on LBIE's bank accounts and transaction accounts (including its core client money bank accounts and client transaction accounts) prior to administration. The amounts paid varied from one bank/clearing house/broker to the next. Interest continues to be paid on these accounts (where there is a credit balance) and accumulates in those accounts.

Some of the amounts held on LBIE's core client money bank accounts and some client transaction accounts have since been transferred into accounts opened in LBIE's name by the Administrators following the time of administration. These accounts have been and are being used exclusively to hold that client money. Some money recovered from other client transaction accounts has been transferred into other accounts opened in LBIE's name by the Administrators following the time of administration, into which post-administration client money has also been paid. These accounts also have been and are being used exclusively to hold client money save that certain post-administration payments have been credited to these accounts pending clarification of whether or not they are client money. Interest earned on all of these amounts is also accumulating in the relevant accounts.



### Third supplement to SAF: LBIE's co-mingled house accounts

- 1** At paragraph 2.20.3 of the SAF, reference is made to certain of LBIE's bank accounts which regularly had house and client transactions processed through them. The SAF further notes that, of these accounts, at close of business on 12 September 2008, 24 had credit balances totalling approximately USD162 million. For the avoidance of doubt, these were the balances left on these accounts following completion of LBIE's liquidity management process for that day. In other words, these accounts were not swept to zero on 12 September 2008.
- 2** In paragraph 20 of Clark 4, it is noted in relation to LBIE's non-core client money bank accounts that much of the money received into these accounts was not money which was required to be segregated by LBIE for the purposes of CASS. Paragraph 23 of Clark 4 sets out details of an analysis undertaken by the Administrators in relation to what activity passed through these accounts in the week prior to LBIE's administration. This analysis indicates that less than 20% of the money which passed through these accounts in that week would have been money which LBIE was required to segregate. The Administrators have not so far undertaken a similar analysis of activity passing through the accounts referred to in paragraph 1 above. However, their expectation is that much of the money which passed through these accounts would not be money which LBIE was required to segregate for the purposes of CASS.