

ENGLAND AND WALES / JUDGMENT

MF Global UK Ltd, Re

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Neutral Citation Number: [2013] EWHC 92 (Ch) IN THE HIGH COURT OF JUSTICE CHANCERY DIVISION COMPANIES COURT Case No: 9527 of 2011 Royal Courts of Justice Rolls Building 7 Rolls Building London EC4A 1NL Date: 29/01/2013 Before : THE HONOURABLE MR JUSTICE DAVID RICHARDS IN THE MATTER OF MF GLOBAL UK LIMITED (IN SPECIAL ADMINISTRATION) AND IN THE MATTER OF THE INVESTMENT BANK SPECIAL ADMINISTRATION REGULATIONS 2011

- ----- Between : RICHARD HEIS, MICHAEL ROBERT PINK and RICHARD DIXON FLEMING (joint administrator of MF GLOBAL UK LIMITED)
- and - Applicants
- (1) ATTESTOR VALUE MASTER FUND LP (as a representative)
- (2) SCHNEIDER TRADING ASSOCIATES Respondents LIMITED (as a representative)
- and - THE FINANCIAL SERVICES AUTHORITY Interested Party
- -----
- ----- Antony Zacaroli QC and Adam Al-Attar (instructed by Weil, Gotshal and Manges) for the Administrators of MF Global UK Limited Richard Snowden QC and Ben Shaw (instructed by Simmons and Simmons) for Attestor Value Master Fund LP Barry Isaacs QC and David Allison (instructed by MacRae & Co LLP) for Schneider Trading Associates Limited Glen Davis QC for the Financial Services Authority Hearing date: 30 and 31 October 2012
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Judgment

Mr Justice David Richards :

Introduction

1. 2. 3. 4. 5. Investment firms are required to segregate money received from or held for their clients and hold it on trust for them. In certain circumstances, including the administration or liquidation of the firm, the money held for clients (client money) must be distributed among the clients, pro rata according to their entitlements. The rules creating this obligation and governing the relevant arrangements are contained in chapters 7 and 7A

(CASS 7 and 7A) of the Client Assets Sourcebook section of the Financial Services Authority Handbook. The value of a client's entitlement for distribution purposes is to be established as at the date when this obligation arises, the primary pooling event (PPE). The issue in this case is whether in calculating a client's entitlement, at least in the context of administration or liquidation, the client's open positions on trades made with the firm are to be valued by reference to market value as at the PPE or by reference to the prices at which the trades are subsequently closed-out, whether at the contractual settlement date or at an earlier date in accordance with applicable default provisions. The issue arises on an application for directions made by the investment bank administrators (the administrators) of MF Global UK Limited (MFG UK). The direction sought is: "Whether a client's client money entitlement in respect of its position is to be valued as at the PPE by reference to the market value or any mark-to-market value as at the PPE or by reference to the liquidation value". For these purposes, "the liquidation value" is defined as "the value of an open position as at the date that position was closed-out". An "open position" is defined as "a transaction, whether a margin transaction or not, between MFG UK and a client or a creditor open as at the PPE". The issue arises because positions which remained open at the PPE applicable to MFG UK were subsequently closed-out at prices which in many cases varied from the market value of the position assessed by reference to prices as at the PPE. Two respondents were joined to represent the clients of MFG UK who would gain from the adoption of one or other of the alternative valuation bases and to advance the case of each group. Mr Snowden QC and Mr Shaw appeared for Attestor Value Master Fund LP (Attestor), the respondent representing the clients whose claims would be higher if open positions were valued by reference to market value as at the PPE. Their positions were closed-out at prices lower than their market values as at the PPE. There are in this category some 370 clients with claims totalling a little under US\$450 million calculated on the basis of the actual closed-out prices. The administrators estimate that their cumulative position would improve by US\$59.1 million if their claims were valued on the basis of market value as at PPE. Mr Isaacs QC and Mr Allison appeared for Schneider Trading Associates Limited (Schneider), the respondent representing the group which would gain if claims are valued by reference to their subsequent closed-out prices. There are some 315 clients in this group with claims totalling a little over US\$244 million, which would reduce, it is estimated, by US\$27.9 million if calculated by reference to market value at the PPE. 1,746 clients with claims totalling about US\$341 million are not affected by this issue. The Financial Services Authority (the FSA), as the body responsible for making and administering the relevant rules, has exercised its statutory right to participate in the application. Appearing by Mr Davis QC, it has drawn attention to relevant considerations and has supported the position for which Attestor argues. The administrators, appearing by Mr Zacaroli QC and Mr Al-Attar, have taken a neutral position. Summarising the respondents' positions in the broadest terms, Attestor submits that valuation by reference to the market value as at the PPE is dictated by the terms of the relevant rules, particularly when read in the light of the majority judgments in the Supreme Court in *Lehman Brothers International (Europe) v CRC Credit Fund Ltd*

- [2012] Bus LR 667 (Lehman). Schneider submits that, just as it applies in the valuation of claims for the purposes of a distribution of a company's assets among its unsecured creditors in a liquidation or administration, the hindsight principle should be applied so that the return of client money is made on the basis of the prices at which open positions are later closed-out. The rules which are most relevant to the issue on this application were the subject of detailed scrutiny in Lehman, albeit largely for the purposes of a different issue (among many raised in that case). The issue was whether the basis on which clients were entitled to participate in the distribution of client money following a PPE was the amount of client money held for them respectively immediately prior to the PPE (the contributions basis) or the amount which the firm should then have been holding for them respectively (the claims basis). At first instance, Briggs J held that the contributions basis applied, but he was unanimously reversed on this issue by the Court of Appeal. The Supreme Court divided on the issue, the majority holding that the claims basis applied, with the leading majority judgment being given by Lord Dyson. It will be necessary to refer to the judgments in Lehman. The numbering of the relevant rules is not the same, but their wording remained the same so far as applicable to MFG UK. MFG UK is a subsidiary of MF Global Holdings Ltd, a company incorporated in Delaware. Companies in the MF Global group carried on business as broker-dealers in financial markets throughout the world. The group's principal operations were in New York and London, carried on by MF Global Inc and MFG UK respectively. These and other companies entered formal insolvency proceedings in the United States and England on 31 October 2011. The administrators of MFG UK were appointed under the Investment Bank Special Administration Regulations 2011. 6. 7. 8. 9.
10. MFG UK acted as a broker-dealer in commodities, fixed income securities, equities, foreign exchange, futures and options, and also provided customer financing and securities lending services. In particular, MFG UK acted as an intermediary broker for the European business of the MF Global group and provided, amongst other services, matched-principal execution and clearing services for exchange trades and over-the-counter (OTC) derivative products, as well as for non-derivative foreign products and securities in the cash markets.
 11. MFG UK entered into bilateral transactions with customers where the customer took a long or short interest in an asset or a derivative of a referenced asset. Normally, MFG UK would hedge its position by entering into a trade with a third party on terms as to payment and delivery which were equal and opposite to the terms of the trade with the customer. MFG UK took both exchange-traded and OTC positions. Exchange-traded positions are traded on a recognised exchange and would include, among other assets, future contracts, options and listed shares. OTC positions are bilateral contracts with a creditor or client that provide the creditor or client with exposure to an asset or derivative that is not traded on a recognised exchange. Such positions would include, among other assets, contracts for differences, foreign exchange related contracts, spread bets and forward contracts and options on referenced assets that are not listed on a recognised exchange.

12. Many of the transactions entered into by MFG UK involved clients taking open positions for which they were required to provide margin, both when the trade was made, by reference to the underlying risk of the position, and on a continuing, normally daily, basis while the trade was open. This variable margin requirement reflected the daily market value of the contract as against the price of the contract at inception. It might increase or reduce the margin requirement, resulting in sums being debited or credited to clients' accounts. CASS 7 and 7A 13. 14. The FSA Handbook contains the rules made, and guidance given, by the FSA in accordance with its powers under Part X of the Financial Services and Markets Act 2000 (FSMA). CASS 7 and 7A were made for the purpose of implementing in the UK the requirements of the Markets in Financial Instruments Directive 2004/39/EC (MiFID) and the Commission Directive 2006/73/EC (the Implementing Directive). The overall purpose of the Directives is to provide a high level of protection to clients. One aspect is safeguarding client money. Recital 26 to MiFID provides: "i. In order to protect an investor's ownership and other similar rights in respect of securities and his rights in respect of funds entrusted to a firm, those rights should in particular be kept distinct from those of the firm". Article 13(8) requires an investment firm: "when holding funds belonging to clients, to make adequate arrangements to safeguard the clients' rights and prevent the use of clients' funds for its own accounts". Article 16 of the Implementing Directive requires the segregation of clients' assets and funds. In *Lehman Lord Dyson* observed at [134]: "It follows that the effect of Article 13(7) and (8) of MiFID and Article 16(2) of the Implementing Directive is that member states are under a duty to prescribe measures that firms should take to ensure that there are adequate arrangements under the domestic law relating to insolvency to safeguard the clients' rights to funds belonging to them in order to achieve the investor protection purpose of MiFID". 15. The means by which this requirement of the Directives has been achieved in England and Wales is, consistently with English law, by the imposition of a trust of client money. Section 139(1) of FSMA specifically provides that rules relating to client money may: "(a) make provision which results in that client's money being held on trust in accordance with the rules;
- (b) treat two or more accounts as a single account for specified purposes (which may include the distribution of money held in the accounts)". By this means the beneficial ownership of client money is kept separate from the assets belonging beneficially to the firm and is not therefore available for distribution in an insolvency among the unsecured creditors of the firm. Clients may, but need not, also be creditors of the firm. But as regards client money held as such by the firm, their rights arise as beneficiaries, not as creditors, and they arise under CASS 7 and 7A, not under the insolvency legislation generally applicable to the firm. Provisions of CASS 7 16. The relevant provisions of CASS 7 and 7A are designated with an R (rule) or a G (guidance), but account must be taken of the latter in interpreting and applying the rules. In quoting them, I have not adopted the technique used in the published provisions of identifying defined terms in italics. 17. CASS 7, known as the client money rules, applies (as provided by CASS 7.1.1R) to: "A firm that receives money from or holds money for, or on behalf of, a client in the course of, or in connection with:

- (3) its MiFID business; and/or
- (4) its designated investment business, that is not MiFID business in respect of any investment agreement entered into, or to be entered into, with or for a client". Money is not client money "when it becomes properly due and payable to the firm for its own account" (CASS 7.2.9R) and ceases to be client money if it is paid to the firm itself when due and payable to it (CASS 7.2.15R). 18. Client money must be segregated from the firm's money by being paid into and held in "an account or accounts identified separately from any accounts used to hold money belonging to the firm" (CASS 7.4.11R). Such account or accounts (client bank accounts) must be held with an authorised bank or other institution falling within the categories defined in CASS 7.4.1R. 19. The trust of client money is created by CASS 7.7.2R which provides: "A firm receives and holds client money as trustee (or in Scotland as agent) on the following terms: (1) (2) (3) (4) (5) for the purposes of and on the terms of the client money rules and the client money distribution rules; subject to (4), for the clients (other than clients which are insurance undertakings when acting as such with respect of client money received in the course of insurance mediation activity and that was opted in to this chapter) for whom that money is held, according to their respective interests in it; after all valid claims in (2) have been met, for clients which are insurance undertakings with respect of client money received in the course of insurance mediation activity according to their respective interests in it; on failure of the firm, for the payment of the costs properly attributable to the distribution of the client money in accordance with (2); and after all valid claims and costs under (2) to (4) have been met, for the firm itself". 20. CASS 7.6 makes provision for records, accounts and reconciliations. CASS 7.6.1R provides: "A firm must keep such records and accounts as are necessary to enable it, at any time and without delay, to distinguish client money held for one client from client money held for any other client, and from its own money". CASS 7.6.2R requires a firm to maintain accurate records which in particular ensure correspondence to the client money held for clients. CASS 7.6.7R requires a firm to maintain records sufficient to show and explain the method of internal reconciliation of client money balances under CASS 7.6.2R. It refers to the "standard method of internal client money reconciliation" which is set out in detail in Annex 1 to CASS 7 to which I refer below. It provides further that, if a firm uses a method of internal reconciliation different from the standard method, its records must be sufficient to show and explain that: "(a) The method of internal reconciliation of client money balances used affords an equivalent degree of protection to the firm's clients to that afforded by the standard method of internal client money reconciliation; and
- (b) In the event of a primary pooling event or a secondary pooling event, the method used is adequate to enable the firm to comply with the client money distribution rules". It follows that the standard method of internal client money reconciliation is considered adequate to achieve those two purposes, if it is properly applied. 21. CASS 7.6.6G gives guidance as to the internal reconciliation of client money balances. Carrying out internal reconciliations of the records and accounts of each client's entitlement to client money with the records and accounts of the client money held by the firm is one of the steps which a firm should take to

satisfy its obligations under CASS 7.6.2R. Such internal reconciliations should be performed as often as is necessary and as soon as reasonably practicable after the date to which the reconciliation relates, to ensure the accuracy of the firm's records and accounts. 22. Annex 1 to CASS 7 sets out in detail the steps involved in the standard method of internal client money reconciliation. Its provisions are important to the issue on this application. Paragraphs 1 and 2 provide: "1. Each business day, a firm that adopts the normal approach (see CASS 7.4.17G) should check whether its client money resource, being the aggregate balance on the firm's client bank accounts, as at the close of business on the previous business day, was at least equal to the client money requirement, as defined in paragraph 6 below, as at the close of business on that day. 2 Each business day, a firm that adopts the alternative approach (see CASS 7.4.18G) should ensure that its client money resource, being the aggregate balance on the firm's client's bank accounts, as at the close of business on that business day is at least equal to the client money requirement, as defined in paragraph 6 below, as at the close of business on the previous day". 23. Paragraph 6 defines "client money requirement" by reference to two alternatives, of which paragraph (1) is most in point: "(1) (subject to paragraph 18) the sum of, for all clients: a) the individual client balances calculated in accordance with paragraph 7, excluding: i) individual client balances which are negative (that is, debtors); and ii) clients' equity balances; and b) the total margined transaction requirement calculated in accordance with paragraph 14." 24. Paragraph 7 of Annex 1 sets out in a table the method of calculating individual client balances for the purposes of paragraph 6. Nothing turns on it for the purposes of the present application. In very broad terms, it aggregates money held by the firm for a client, whether free money or money relating to a transaction where the client has fully performed its obligations, and deducts money owed by the client to the firm for the purchase of investments which have been delivered to the client and the proceeds of sales remitted to the client where the client has not yet delivered the relevant investments. 25. The definition of "client equity balance", which is referred to in paragraph 6, is of central importance to the issue on this application. It appears in the Glossary to the FSA Handbook and reads: "The amount which a firm will 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 were 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". 26. A margined transaction is defined in the Glossary so as to include: "A transaction executed by a firm with or for a client relating to a future, option or contract for differences (or any right to or any interest in such an investment) under the terms of which the client will or may be liable to provide cash or collateral to secure performance of obligations which he may have to perform when the transaction falls to be completed or upon the earlier closing out of his position". 27. Paragraph 14 of Annex 1 to CASS 7 sets out the basis of the calculation of the "total margined transaction requirement" for the purposes of paragraph 6(1)(b) as: "(1) The sum of each of the client's equity balances which are positive; Less

- (2) The proportion of any individual negative client equity balance which is secured by approved collateral; and
- (3) The net aggregate of the firm's equity balance (negative balances being deducted from positive balances) on transaction accounts for customers with exchanges, clearing houses, intermediate brokers and OTC counterparties". 28. The firm's equity balance for the purposes of paragraph 14(3) is defined in similar terms to the client equity balances by paragraph 13: "A firm's equity balance, whether with an exchange, intermediate broker or OTC counterparty is the amount which the firm would be liable to pay to the exchange, intermediate broker or OTC counterparty (or vice versa) in respect of the firm's margined transactions if each of the open positions of the firm's clients was liquidated at the closing or settlement prices published by the relevant exchange or other appropriate pricing source and the firm's account with the exchange, intermediate broker or OTC counterparty is closed". 29. 30. Paragraph 18 of Annex 1 permits, but does not require, a firm to offset, on a client by client basis, a negative amount with a positive amount arising out of the calculations in paragraphs 7 and 14 and, by so doing, reduce the amount the firm is required to hold as client money. It is helpful to summarise the obligations imposed on firms by CASS 7 before moving on to the client money distribution rules in CASS 7A. Client money must be segregated from the firm's own money and held in separately designated accounts. It is held by the firm on the trusts declared by CASS 7.7.2R. It is therefore not part of the firm's own assets. The firm is required to carry out on a daily basis a 31. 32. reconciliation to ensure that the client money held by it is at least equal to the client money requirement, as defined in Annex 1. This may be carried out by reference to the individual client balances and clients' equity balances as at the close of business on the previous business day. An integral part of the calculation of the client money requirement is the ascertainment of the client equity balances, which requires a notional closing out of all open positions on the clients' margined transactions "at the closing or settlement prices published by the relevant exchange or other appropriate pricing source". Mr Snowden aptly described this as a fundamental building block of the regime. Provisions of CASS 7A CASS 7A contains the client money distribution rules. They apply "to a firm that holds client money which is subject to the client money rules when a primary pooling event or a secondary pooling event occurs". A secondary pooling event occurs on the failure of a third party holding client money for a firm. The present case involves a primary pooling event which is defined in 7A.2.2R as occurring on any of the following events: "(1) on the failure of the firm;
- (2) on the vesting of assets in a trustee in accordance with an 'assets requirement' imposed under section 48(1)(b) of the Act;
- (3) on the coming into force of a requirement for all client money held by the firm; or
- (4) when the firm notifies, or is in breach of its duty to notify the FSA, in accordance with CASS 7.6.16R (Notification requirements), that it is unable correctly to identify and allocate in its records all valid claims arising as a result of a secondary pooling event." The "failure" of a firm is defined in the Glossary as meaning "the appointment of a liquidator, receiver,

administrator, or trustee in bankruptcy, or any equivalent procedure in any relevant jurisdiction". 33. The pooling and distribution of client money which follows a primary pooling event is set out in 7A.2.4R: "If a primary pooling event occurs:

- (1) client money held in each client money account of the firm is treated as pooled; and
 - (2) the firm must distribute that client money in accordance with CASS 7.7.2R, so that each client receives a sum which is rateable to the client money entitlement calculated in accordance with CASS 7A.2.5R." 34. CASS 7A.2.5R makes provision for set-off as follows: "(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." The set-off provided by this rule reflects the provision for set-off contained in paragraph 18 of Annex 1 to CASS 7 but instead of being permissive it is, in the event of a primary pooling event, mandatory. 35. CASS 7A.2.7R makes special provisions with respect to client money received after a primary pooling event. Such money must not be pooled with client money already held by a firm at the time of the primary pooling event but must be held in a separate client bank account and returned to the relevant client without delay. The exceptions to this rule are, first, where it is client money relating to a transaction that has not settled at the time of the primary pooling event and, secondly, where it is client money relating to a client "for whom the client money entitlement, calculated in accordance with CASS 7A.2.5R, shows that money is due from the client to the firm at the time of the primary pooling event". The parties' submissions
36. Mr Snowden QC, on behalf of Attestor, submitted that the issue in this case turns on the application of the provisions of CASS 7A.2.4R and CASS 7A.2.5R. The requirement of CASS 7A.2.4R(2) is that the firm must distribute pooled client money in such a way that each client receives a rateable proportion of the client money entitlement calculated in accordance with CASS 7A.2.5R. The constituent elements of that calculation are the client's individual client balance and its client equity balance. Those constituent elements are defined by the provisions to which I have earlier referred. To the extent that one is negative and the other is positive, CASS 7A.2.5R requires a set-off. Critically, for present purposes, client equity balances are defined in the Glossary by reference to a notional closing-out of open positions "at the closing or settlement prices published by the relevant exchange or other appropriate pricing source". Mr Snowden submitted that this leaves no room for the substitution of a different figure calculated by reference to the actual prices at which open positions are in fact subsequently closed-out.
37. Mr Davis QC, on behalf of the FSA, supported the approach adopted by Mr Snowden. He pointed out, first, that the valuation of client equity balances was not a valuation on a contingent basis but a valuation on the basis of an assumed close-out. In those

circumstances hindsight had no part to play. Secondly, the CASS rules dealing with client money are independent of the general law as to insolvency. While pooling and distribution echo insolvency procedures, the context is quite different. The relevant CASS rules are concerned with the pooling and distribution of trust assets. They come into operation not just in the event of a formal insolvency but whenever a primary pooling event occurs. Some formal insolvency processes, such as administration, may not necessarily involve any distribution from the general estate.

38. Mr Isaacs QC, on behalf of Schneider, began his submissions with three broad propositions. First, prior to and at the time of a PPE, a client has two sets of rights. He has a personal right under his contract to payment of the amount which may fall due on the settlement of the transaction in accordance with its terms. At the time of the PPE, in the case of open positions, this is a contingent claim. The amount, if any, payable to him depends on future market movements and the price at which the contract closes out in accordance with its terms. He also has a proprietary right to participate in the distribution of pooled client money in accordance with CASS 7A. Secondly, in the case of a PPE which is the commencement of a liquidation or administration, the calculation of a client's personal claim arising under his contract is subject to the provisions of the applicable insolvency law. In particular, this will involve the application of the hindsight principle, so that if the contract closes out between the commencement of the insolvency process and the date of a distribution to an unsecured creditor the amount, if any, then payable to the client will be treated as his claim as at the date of the insolvency event. Thirdly, the client money entitlement is to be calculated in accordance with CASS 7 and 7A. There is nothing controversial about any of these propositions as so stated, subject to a note of caution on the application of the hindsight principle to the estimation of personal claims which I mention below. The controversy arises in relation to the approach to be adopted to the proper construction and application of CASS 7 and 7A. By way of important background to his submissions on the proper construction on the client money distribution rules, Mr Isaacs developed submissions as to the importance of the hindsight principle in effecting a *pari passu* distribution of a fund on a fair basis. He cited a number of the leading authorities on its application in the context of a distribution of a company's assets on an insolvency and submitted in effect that there should be a strong disposition on the court's part to apply hindsight in calculating the entitlements to any fund which is to be distributed on a *pari passu* basis. He pointed out that CASS 7A.2.4R requires a pooling of client money on the occurrence of a primary pooling event and its distribution among clients rateably according to their individual client money entitlements. In addition to the general requirement of fairness, Mr Isaacs developed submissions as to why in the context of the client money distribution rules the application of the hindsight principle would promote consistency and avoid anomalies. Turning to the construction of the client money distribution rules in CASS 7A, Mr Isaacs made five principal submissions. His first submission was that, although CASS 7A.2.4R states that the client money entitlement is to be "calculated in accordance with CASS 7A.2.5R", the latter rule does not in fact define how the client money entitlement is to be

calculated. CASS 7A.2.5R provides only for a mandatory set-off between positive and negative balances on individual client balances and client equity balances. Mr Isaacs pointed out that CASS 7A.2.5R is silent as to how client money entitlement is to be calculated in a number of other possible situations, such as when the individual client balance and the client equity balance are either both positive or both negative or when either is zero. Most importantly, CASS 7A.2.5R says nothing as to whether client money entitlement is to be calculated with or without hindsight. Because its scope is limited to that of a mandatory set-off provision, the answer as to whether or not hindsight is to be applied is not to be found in that rule. The second principal submission was that the non-application of hindsight cannot be derived from the definition of client equity balance contained in the Glossary, contrary to the submissions of Mr Snowden and Mr Davis. Mr Isaacs submitted that the definition is consistent both with the use of mark to market values on a notional close-out when the firm carries out the daily reconciliation and with the use of liquidation values when calculating client equity balances as at the PPE for the purposes of the client money distribution rules. For this purpose, Mr Isaacs laid heavy stress on the phrase in the definition of client equity balance, “at the closing or settlement prices published by the relevant exchange or other appropriate pricing 39. 40. 41. 42. 43. 44. 45. source”. Closing or settlement prices published by the relevant exchange is a reference to mark to market values and applies to the daily ascertainment of client money equity balances for the purposes of segregation. For the purposes of calculating client equity balances in the context of the distribution of client money under CASS 7A, the words “other appropriate pricing source” are apt to bring into play the prices at which transactions are subsequently closed out for the purpose of applying the hindsight principle. Even so, Mr Isaacs submitted that one only gets to the definition of client equity balance in those cases where CASS 7A.2.5R applies, that is to say where there is a negative and positive balance on a client’s individual client balance and its client equity balance. In all other cases, it is unnecessary to grapple with the definition of client equity balance and it is both open and appropriate for the hindsight rule to be applied as a matter of general principle. Mr Isaacs submitted that his approach is supported by the judgments in the Court of Appeal and the majority in the Supreme Court in *Lehman*, to which I will later return. Mr Isaacs also relied in this context on the second exception in CASS 7A.2.7R and again I will return to this. The third principal submission was that without the application of the hindsight rule CASS 7A gives rise to some surprising consequences. It is very likely that the notional closing out of an open transaction as at the date of PPE will differ from the price at which the transaction is in fact subsequently closed out. If the price moves against the client after the PPE, it follows that he will be entitled to a greater proportion of the client money than is necessary to provide protection for his actual claim. It may even be that the client is entitled to share in a distribution of the client money, even though following the close-out of the transaction he is a debtor of the firm. Conversely, if the price moves in the client’s favour, the proportion of the client money to which he is entitled will be less than that required to provide the protection to which he is entitled. This produces results which are contrary to “the high level of protection” required for clients by MiFID.

46. Mr Isaacs' fourth principal submission was that the application of the hindsight principle is consistent with the purpose of the client money rules. For this submission, Mr Isaacs relies on expert evidence filed on behalf of Schneider which, he submits, demonstrates that market to market values may not in some cases be good evidence of market value as at the PPE. In particular, in the case of an illiquid instrument, there may not be any reliable quoted market prices, and similar points can be made in respect of other considerations such as the size of any particular position. CASS 7 and 7A must be construed in a way which is capable of application to all types of financial instruments falling within those provisions, not just the most liquid instruments or those most frequently traded. Hindsight will provide a degree of certainty and consistency which is lacking if market values are to be used. The hindsight rule will avoid arguments by clients as to the proper market value to be applied to the instruments held by them. Mr Isaacs submitted that this promotes the objective identified in CASS 7A.1.2G that "the client money distribution rules seek to facilitate the timely return of client money to a client in the event of the failure of a firm".
47. Mr Isaacs' fifth principal submission refers to previous authorities which may be taken as contrary to his client's position. I will deal with those authorities later. The hindsight principle 48. Before coming to these submissions, I will say something about the hindsight principle. It is a principle of general application that where the amount of a contingent or an unascertained claim must be estimated for the purposes of a distribution or payment, and the amount of the claim becomes certain before the distribution or payment, the latter amount will be taken as the claim's value. The process of estimation is designed to value as accurately as possible the prospect of the contingency occurring or the likely amount of the claim. The use of hindsight either removes the need to make the estimate or makes the estimate more accurate and produces what may generally be regarded as fairer values for the purposes of the distribution or payment. In *Bwllfa and Merthyr Dale Steam Collieries (1891) Ltd v The Pontypridd Waterworks Co* [1903] AC 426, Lord Halsbury LC at p.429 rejected the proposition that "because you could not arrive at the true sum when the notice was given, you should shut your eyes to the true sum now you do know it, because you could not have guessed it then". The most common circumstances for the application of the hindsight principle are the distribution of the assets of insolvent companies or individuals. Legislative changes in the 19th century enabled contingent or unascertained claims to be proved in bankruptcy or liquidation. Section 158 of the Companies Act 1862 provided for such claims to be admissible to proof in a liquidation, "a just estimate being made, so far as is possible, of the value of all such debts or claims as may be subject to any contingency or sound only in damages, or for some other reason do not bear a certain value". The requirement of an estimate of such claims has continued throughout all the subsequent legislation: see now rule 4.86 of the Insolvency Rules 1986. Ever since contingent and unascertained claims became admissible to proof, the courts have applied the hindsight principle. An early example was *In re Northern Counties of England Fire Insurance Co, Macfarlane's Claim* (1880) 17 Ch D 337. An insured's premises were burnt down during the winding-up. His claim was contingent as at the date of winding up, but in determining the

amount for which he could prove, both the fact of the fire and the value of the damage were accepted. In *M. S. Fashions Ltd v BCCI* [1993] Ch 425 at 432, Hoffmann LJ described the hindsight principle as “pervasive in the valuation of claims and the taking of accounts in bankruptcy and in winding up”. In *Stein v Blake* [1996] 1 AC 243 at 252, Lord Hoffmann described the principle as follows: 49. 50. 51. “How does the law deal with the conundrum of having to set off, as of the bankruptcy date, “sums due” which may not yet be due or which may become due upon contingencies which have not yet occurred? It employs two techniques. The first is to take into account everything which has actually happened between the bankruptcy date and the moment when it becomes necessary to ascertain what, on that date, was the state of account between the creditor and the bankrupt. If by that time the contingency has occurred and the claim has been quantified, then that is the amount which is treated as having been due at the bankruptcy date.” In *Wight v Eckerhardt Marine GmbH* [2004] 1 AC 147 at [32], Lord Hoffmann explained the rationale of the principle: “These cases on the use of hindsight to value debts which were contingent at the date of the winding-up order show that the scene does not freeze at the date of the winding-up order. Adjustments are made to give effect to the underlying principle of *pari passu* distribution between creditors. Hindsight is used because it is not considered fair to a creditor to value a contingent debt at what it might have been worth at the date of the winding-up order when one knows that prescience would have shown it to be worth more.” 52. 53. 54. The use of the hindsight principle in a liquidation (and also, now, in an administration) has since 1986 been expressly recognised in the applicable legislation. Rule 4.86 of the Insolvency Rules provides that a liquidator “may revise any estimate previously made, if he thinks fit by reference to any change of circumstances or to information becoming available to him”. Pervasive as the hindsight principle is in insolvency, it is not universal. As Mr Davis QC pointed out, the decision in *In re Northern Counties of England Fire Insurance Co* was reversed by the Assurance Companies Act 1909. Under provisions now contained in the Insurers (Winding Up) Rules 2001, the claim for the unexpired portion of a fixed policy period is the rateable proportion of the policy premium. Different rules apply to different types of general and long-term policies. It is relevant to emphasise a feature of the hindsight principle which is of particular significance to the present case. It applies where claims are being estimated. The process of estimation aims to assess the likelihood of the occurrence of the relevant contingency and the amount likely to become due on such occurrence or to predict the outcome of a process of quantifying a sum which is unascertained at the relevant date. It is essentially a process of putting a present value on possible future events or outcomes.

55. When valuing unsecured claims by clients of MFG UK for the purposes of proof of debts and the distribution of the general assets of MFG UK, the administrators propose to apply the hindsight principle to claims in respect of contracts which were open at the commencement of the administration. Many of them were as at that time contingent claims. Both the existence of a claim and its amount were contingent on the ultimate close-out position. While as a matter of general principle this approach would seem to be right (see rule 160 of the Investment Bank Special Administration Rules 2011), I must emphasise that it is not an

issue raised on this application. Mr Snowden QC cautioned me against expressing views on it, in the absence of any evidence as to the details of the contracts affected. While hindsight may be applicable to some contracts, it may not be applicable to others. Additionally, if the early close-out of a contract was not in accordance with its terms, it may not be the close-out price which fixes the amount of the firm's liability. Does the hindsight principle apply to the valuation of client money entitlements? 56. 57. As all parties agree that the issue raised in this case is governed by the proper construction and application of CASS 7 and 7A, it is right to start with their provisions. It is common ground that by reason of CASS 7A.2.4. R(2) the distribution of the pooled client money is to be made rateably according to each client's "client money entitlement". As was observed in some of the judgments in Lehman, it is a striking and unhelpful feature of the CASS provisions that "client money entitlement" is not defined. Mr Isaacs built on the lack of a definition and the limited ambit of CASS 7A.2.5R for his principal submission that this gap in the rules should be filled by the use of the hindsight principle, as the basis generally recognised by the law as fair and sensible for the distribution of a fund or estate with a shortfall of assets against claims.

58. Mr Isaacs accepted that the client money entitlement was to be determined as at the date of the PPE, as appears clearly from CASS 7A.2.7R(2) and also, though less clearly, from CASS 7A.2.4R. The hindsight principle can be applied to the quantification of claims as at that date just as it can to the quantification of creditors' claims as at the relevant date in a liquidation, administration or bankruptcy. 59. 60. These submissions echo submissions made in Lehman but rejected by the Court of Appeal and the majority in the Supreme Court. The absence of a definition of client money entitlement was responsible for the main issue on which the Supreme Court divided, but the majority was clear as to its meaning. It was, as Lord Collins of Mapesbury put it at [196], "a reference to the contractual entitlement to have money segregated for the client." The submission that the provision in CASS 7A.2.4R(2) for client money entitlement to be "calculated in accordance with CASS 7A.2.5R" gave only limited assistance, because CASS 7A.2.5R was no more than a provision for set off in limited circumstances, precisely mirrored a submission made in Lehman, recorded at [255] in the judgment at first instance of Briggs J: see [2009] EWHC 3228 (Ch); [2010] 2 BCLC 301. This submission was accepted by Briggs J but rejected by the Court of Appeal and the majority in the Supreme Court. 61. The alternative submission on the proper construction of CASS 7A.2.4R and 7A.2.5R was set out by Briggs J at [242]: "I have already quoted the relevant parts of CASS7.9.6R, 7R and 9R at para [125] above. The argument of the proponents of a claims basis for distribution, based on these paragraphs, runs as follows:

- (i) CASS7.9.6R(2) requires the firm to distribute client money 'in accordance with CASS7.7.2R, so that each client receives a sum which is rateable to the client money entitlement calculated in accordance with CASS7.9.7R' (my underlining). (ii) CASS7.9.7R requires, on a client by client basis, a netting process to be carried out between each client's 'individual client balance' and that client's 'client equity balance'. (iii) CASS7.9.9R(2) makes it clear (albeit for a different purpose) that the 'client money entitlement' for each client will be calculated in accordance with CASS7.9.7R as at the time of the PPE. (iv) The phrase 'client

equity balance' is defined in the glossary by reference to the amount which a firm would be liable to pay to a client in respect of that client's margined transactions if each of his open positions was liquidated at the prices published by the relevant exchange and his account closed. It is a form of entitlement having nothing to do with the amount contributed by the client to the firm's segregated accounts.

- (v) The phrase 'individual client balance' is not a term defined in the glossary, but it is fully explained in para 7 of Annex 1, again in terms which are based upon the contractual position between the client and the firm, rather than the amount actually contributed by the client to the firm's segregated accounts. (vi) Thus it necessarily follows that the phrase 'client money entitlement', where used both in CASS 7.9.6R(2) and 7.9.9R(2) is a reference to the client's contractual entitlement to have money segregated for it, rather than to the client's proprietary interest in the CMP, derived from having had its money actually segregated, i.e. paid into the segregated accounts from which the CMP is constituted." 62. Briggs J rejected this "formidable textual argument" but it was accepted by the Court of Appeal and the majority in the Supreme Court. Counsel for the non-segregated clients in Lehman relied on this argument, based on the reference to a calculation "in accordance with" CASS 7.9.7R (now 7A.2.5R), as supporting the claims basis for participation in a distribution of the pooled client money, a submission accepted by the majority in the Supreme Court. 63. At [153], Lord Dyson, giving the leading majority judgment in the Supreme Court, said: "Both the judge, at para 232, and Lord Walker, at para 97, said that the purpose of 7.9.7R is obscure and, at least by inference, that the reference to it in 7.9.6R(2) cannot bear the weight that Mr Miles seeks to place on it. But I do not think that the reference in 7.9.6R(2) to the sum being calculated "in accordance with CASS 7.9.7R" can be brushed aside so easily. CASS 7.9.7R provides for a calculation which takes account of each client's "individual client balance" and "client equity balance". The individual client balance calculation is dealt with in detail in paragraph 7 of Annex 1." 64. Lord Dyson also considered, as had the Court of Appeal, that this approach was supported by what is now CASS 7A.2.7R(2). He said at [158]: "This creates an exception from the usual rule that all client money received by the firm after a PPE must be returned to the client. The exception is where 'it is client money relating to a client, for whom the client money entitlement, calculated in accordance with CASS 7.9.7R [now 7A.2.5], shows that money is due from the client to the firm at the time of the primary pooling event'. This is a reference to a calculation being performed in manner prescribed in Annex 1 (albeit with a mandatory off-setting). The exercise is intended to establish whether, objectively and in fact, the client is a debtor of the firm, in which case the firm can keep the money. In the context of 7.9.9R(2) [now 7A.2.7(2)], 'client money entitlement' has nothing to do with the amounts actually segregated for a client by the firm. It is telling that 7.9.9R(2), like 7.9.6R(2), requires the client money entitlement to be calculated in accordance with 7.9.7R" (emphasis added) as at the date of the PPE. 65. The decision of the majority in Lehman is clear authority that the amount of the client money entitlement of each client is to be ascertained by reference to their individual client balances and client equity balances as determined in accordance with Annex 1 to CASS 7, subject to the one modification provided

by CASS 7A.2.5R that set-off between the two balances is to be mandatory, not voluntary. As Lord Dyson said at

- [158] the calculation is to be “performed in the manner prescribed in Annex 1 (albeit with mandatory off-setting).” 66. There is no gap in the CASS rules which requires to be filled by the hindsight principle, operating as a default mechanism. This is hardly surprising when it is recalled that CASS 7 and 7A are intended to be a code giving effect to the relevant Directives: see Lord Clarke of Stone-cum-Ebony at [110] and [121], Lord Dyson at
- [129] and Lord Collins at [196]. In the Court of Appeal, Lord Neuberger said at [226]: “So, too, I consider that it could be dangerous to look at the normal rules relating to trusts: CASS 7 is intended to be a code, and while it will have some ‘gaps’ which will have to be filled in by the general law, it is dangerous to assume that the general law is intended to be followed by specific provisions.”
67. Mr Isaacs relied on the many statements in the judgments of the majority in the Supreme Court to the client money entitlement being a reference to contractual entitlements. He submitted that the hindsight principle, by quantifying claims by reference to the actual prices at which clients’ contracts are closed out, will give effect to their contractual entitlements, unlike the use of notional close-out prices as at the PPE date. However, these references were not to contractual entitlements in general but specifically to the clients’ entitlement to have their client money segregated and held on trust for them. They do not provide support for the application of the hindsight principle. 68. Likewise, Mr Isaacs cannot find support in what Arden LJ said at [163] of her judgment in the Court of Appeal ([2010] EWCA Civ 917; [2011] Bus LR 277): “CASS 7 achieves as it were a mini-liquidation of monies now representing all client money in which all claimants in respect of client money of the firm share.” This is a description of the process of rateable distribution of a fund with a shortfall, not a suggestion that general principles applicable in the liquidation of a company should come into play. It is true that Arden LJ saw more scope for the application of general principles of trust law, and perhaps general principles applicable to *pari passu* distributions, than Lord Neuberger or the majority in the Supreme Court, but not where, as she held in common with the other members of the Court of Appeal and the majority of the Supreme Court, the matter was covered by the terms of CASS 7. She also emphasised at [58] the point that: “Since the rules are designed to protect investors...the court should lean against interpretations which result in legal ‘black holes’. The court has at least to start out with the view that the drafter intended to create a coherent scheme even if this is ultimately disproved in certain respects.” 69. On the basis, as I have held, that the client money entitlement is to be ascertained by a calculation of each client’s individual client balance and client equity balance in accordance with Annex 1 to CASS 7, with the mandatory set-off provided by CASS 7A.2.5R, Mr Isaacs submits in the alternative that the hindsight principle is to be applied by virtue of the definition of “client equity balance”. I have earlier set out the definition and summarised Mr Isaacs’ submissions on it. In short, his submission is that the phrase “or other appropriate pricing source” brings the hindsight principle into play when

client equity balances are determined for the purpose of giving effect to the client distribution rules in CASS 7A. 70. I am unable to accept this submission for a number of reasons. 71. 72. 73. 74. 75. 76. 77. 78. The definition of client equity balance applies as a whole for all purposes under Annex 1 to CASS 7. The whole of it applies as much to the daily reconciliation which firms must undertake while in business as to a distribution following a PPE. There is no suggestion in the definition or in the rules that, while the notional closing-out at published closing or settlement prices applies to the daily reconciliation, the use of other appropriate pricing sources is to apply in the case of a distribution under CASS 7A. Both the language of the definition and its purpose are inconsistent with any such division. As to the language used, the entire definition posits a notional exercise. The client equity balance is “the amount which a firm would be liable...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...” It is the whole of that phrase which governs the reference to prices which follows. The notional liquidation values are calculated with reference to “the closing or settlement prices published by [either] the relevant exchange or other appropriate pricing source” (the word in square brackets and emphasis added). As for the purpose of the provision there will in the case of some contracts, securities or commodities, be no relevant exchange, in which case an alternative and appropriate pricing source is required, in order to carry out the daily reconciliation. Mr Isaacs accepts, as he must, that this cannot be actual close-out prices in the context of daily reconciliations. Mr Isaacs’ submission therefore requires the words “or other appropriate pricing source” to perform two quite different functions. The first is to provide an alternative to exchange prices for the purpose of the daily reconciliation and the second is to provide the exclusive basis on which open positions as at the PPE date are valued when they are subsequently closed. There is in my judgment simply no way in which this single definition can be construed as producing these different and contradictory results. The only available reading is that the client equity positions are to be valued for the purposes of distribution under CASS 7A in precisely the same way as they are valued for the purpose of daily reconciliations. There is no indication in the CASS rules that the hindsight principle is to be applied. If it had been intended that open positions on the occurrence of a PPE should be valued for the purposes of a distribution by reference to actual close-out prices, CASS 7A, Annex 1 to CASS 7 and the definition of client equity balance would have been drafted very differently. They would first have drawn the distinction between valuation for daily reconciliation and valuation for distribution. Secondly, the hindsight principle would have been clearly expressed. As Mr Snowden pointed out, there are a number of readily available precedents such as rule 4.86 of the Insolvency Rules 1986. I earlier stressed that the hindsight principle is used where an estimate is to be made of a claim as at a particular date, assessing the chances of the contingency occurring and the likely amount of any claim. CASS 7 and 7A require the quite different process of a notional valuation of open positions as at a particular date, in this case the PPE date. There is, I consider, no ambiguity or uncertainty in the definition and therefore the submission based on the advantages of using hindsight do not come into play, but if they did, they would not in my view be strongly persuasive. First, Mr Isaacs relied on expert evidence adduced by Schneider to show that in

the case of complex or unusual contracts, securities and commodities there may be considerable difficulty in finding an appropriate pricing source and attributing a notional close-out price. Allied to this, it was submitted that the use of hindsight would reduce the scope for dispute arising from the use of notional prices and therefore make for a more timely distribution. As against that, the use of notional prices, including those derived from appropriate sources other than exchanges, is a feature of the daily reconciliation carried out by firms and there is no evidence that it does not work satisfactorily. The use of notional prices as at the PPE date will provide the speediest basis for ascertaining client equity balances, save in those cases where real difficulties emerge on a scale large enough to disrupt the distribution of the fund. Most such difficulties, if they were to arise, could be met by an appropriate retention pending resolution of the difficulty. In any event it is far from clear that a client would have grounds for challenging the use by the administrators of the same pricing source as had previously been used by the firm for the purposes of daily reconciliations. Further, there would also be scope for disputes if the hindsight principle were adopted, regarding the dates and prices at which the administrators had closed out positions within their control. There could also be contracts which have not been closed out by the time of the distribution of client money, although Mr Isaacs considered it very unlikely. In those cases, however, he accepted that notional prices as at the PPE date would have to be used. Secondly, Mr Isaacs submitted that hindsight would promote consistency with the position as regards proof of debts in the liquidation or administration of the firm. The loss or profit actually made by a client would provide both the basis of his client equity balance and the amount if any of any contractual claim against the firm. While true, this submission does not take account of the status of the CASS rules as constituting a trust fund separate from the firm's assets. It is an important feature of that separate status that CASS 7A will come into operation not only if there is a "failure" of the firm involving a formal insolvency procedure but in the other circumstances specified in CASS 7A.2.2R. Further, the administration of a firm will not necessarily involve a distribution of assets among unsecured creditors. Thirdly, Mr Isaacs submitted that the use of hindsight fulfils the underlying purpose of providing a high level of protection to clients in a way that is not achieved by the use of notional close-out prices as at the PPE date. The premise is that client money is deposited by the client and held by the firm to meet the liabilities if any arising on the actual close-out of positions and therefore hindsight provides a more accurate calculation of clients' ultimate entitlement to client money. Assuming the premise to be correct, as to which I express no view as it would require more detailed investigation of the workings of the client money rules than was undertaken in the submissions to me, I would accept that, if the FSA had chosen to adopt hindsight in the calculation of client money entitlement on the occurrence of a PPE, its choice could not be criticised as irrational. But nor, in my view, can its choice of notional close-out prices, so clearly in my view demonstrated by the terms of CASS 7 and 7A. Notional close-out prices produce consistency both with the daily reconciliation regime and across claims as at the PPE date and may assist in a timely distribution of client money. These are essentially policy considerations for the FSA in the way it frames the CASS rules. 79. 80. 81. Expert evidence 82. Schneider sought and

was given permission to adduce expert evidence on “the extent to which it is possible, in relation to the range of financial instruments to which CASS 7 applies, to estimate the market value and mark-to-market value of open positions” at the PPE of a firm. It filed a report by Dr M. Desmond Fitzgerald, and Attestor responded with a report by Mr Matthew Evans. The experts discussed the issue and prepared an agreed statement of the matters on which they were agreed and on which they disagreed.

83. Mr Isaacs submitted that the expert evidence demonstrated that mark-to-market values may not provide good evidence of the market value of open positions as at the PPE. The extent to which this is the case depends on a range of factors, including liquidity, size, and the nature of the underlying asset. As regards over the counter (OTC) products, rather than exchange-traded products, there may be significant pricing uncertainties or inaccuracies.
84. Mr Isaacs relied on this evidence to suggest that it cannot be the intention of the client money distribution rules to fix the clients’ rateable shares by reference to such an uncertain basis and that the only accurate means of establishing the actual value of clients’ individual open positions is to rely on the prices at which they were in fact closed out. 85. The experts were agreed on a number of matters, including in particular the following: “1. As it relates to the expert question, daily closing or settlement prices will likely be available for exchange-traded contracts, and other pricing available for Over The Counter contracts, for purposes of daily Mark To Market valuations of the range of instruments to which CASS 7 applies. 2. As it relates to the expert question, that in the specific circumstances of the instruments affected by the MF Global PPE, daily closing or settlement prices would likely be available for exchange traded contracts, and other pricing for Over The Counter contracts, for the purposes of Mark To Market valuations as at October 31 2011. 3. That daily settlement and closing prices published by the exchanges or other available OTC prices, are widely used to assess the daily running Profit/Loss on a set of open positions, and to determine position valuations which, in turn, determine the required margins on a customer’s positions. 4. That daily settlement and closing prices published by the exchanges or other available OTC prices, are generally considered to exclude liquidity and slippage costs. That Brokerages and clearinghouses tend to deal in 5. assets for which daily, end of day, closing or settlement prices, or other available OTC prices, are readily available. That market risk and credit analysis, both internally at 6. financial institutions and externally, frequently use daily closing or settlement prices (or other pricing information from the OTC market) and Mark To Market valuations that derive from these types of prices.” MFG UK was a brokerage firm falling within paragraph 5. 86. 87. 88. 89. 90. 91. 92. 93. The expert evidence shows that a lack of up to date and accurate pricing information is not an issue for the great majority of contracts traded by firms such as MFG UK and that, even in relation to unusual contracts, there are pricing sources, however imperfect, on which the daily reconciliations can be carried out. At Schneider’s request, the administrators provided information that in a very small number of cases (131 clients, with a combined value of claims in the region of \$10m) there was difficulty in arriving at a value as at the PPE date. The administrators’ information also shows that on the basis of available information it was possible to arrive at a value. I do

not consider that this expert and other evidence can provide a basis for construing the client money distribution rules as requiring the use of hindsight and the substitution of factual close-out prices for notional prices as at the PPE date. The FSA can be taken to know that the actual prices for traded assets on a particular date will depend on issues such as liquidity, size of the contract, precise market conditions as at the time of the trade and so on. Likewise, the range in the accuracy of pricing information available, depending on the type of contract, is equally well-known to market participants and the FSA. It is clear from the definition of client equity balance that it is not intended to fix the precise value at which each open position would in fact be closed out when daily reconciliations are carried out, and there is no basis for considering that the intention is any different on the occurrence of a PPE. The adoption of the actual closed-out prices would not produce accurate prices and values as at the PPE date. There will often be changes in market conditions between the PPE date and the close-out date, and they may well be significant. There is no perfect system for establishing the figures at which open positions would close-out on the PPE date. In my judgment, the FSA has taken the policy decision to adopt the same basis as applies to the daily reconciliations for understandable reasons of consistency, simplicity and speed.

Previous authority The issue in the present case has been considered and decided in two judgments at first instance. In *re Global Trader Europe Ltd* [2009] EWHC 699 (Ch), [2010] BCC 729 (Global Trader) was an application before me for directions by the liquidators of an investment firm as to the date at which the interests of clients in client money should be valued for the purposes of a distribution under the CASS rules and the date for valuation of unsecured claims in respect of trades for the purposes of proof in the liquidation. The firm went into administration on 15 February 2008, thereby causing a PPE under the CASS rules, and into creditors' voluntary winding-up on 17 June 2008. There could be no dispute that the latter was the correct date for valuing claims for the purposes of proof in the liquidation under the rules then applicable. The direction given in that respect included reference to the hindsight principle by providing, as set out in [10]: "The Liquidators shall value claims made in the liquidation against the Company (including claims by CA Clients for profit in respect of Open Positions which were subsequently closed) as at the date of liquidation. In respect of each Open Position which was closed during the administration or liquidation of the Company, the Liquidators shall quantify the claim against the Company using the price at which the position was closed by the Company, save that where a client complained, in accordance with the terms and conditions of the Company, about the closing of a position which was closed in breach of those terms and conditions, the Liquidators shall, subject to the right of the client to apply to the Court in respect of the Liquidators' quantification of the claim, be at liberty to quantify the client's claim using a price other than that at which the position was closed by the Company." The reason for the exception is explained in [12] – [13].

94. As regards claims to client money, I said at [14]: "14. Different considerations apply to segregated clients claiming a share of the funds held on trust for them in the segregated accounts. The critical point is that, as trust money, the balances on the trust accounts are not assets of GTE and they are not available for distribution among creditors proving in the liquidation. The rules as to proof for unsecured claims, including rules relating to the date of

valuation of claims, are irrelevant. The basis of distribution of the credit balances on the trust accounts is governed by the terms of the trust applicable to those accounts.” After referring to the relevant provisions of the CASS rules, including CASS 7.7.2R, what is now CASS 7A.2.4R and 7A.2.5R, and the definition of client equity balance, I continued: “20. Against the background of these rules, the liquidators sought directions as to the date of valuation of clients’ claims against the funds in the client accounts and in particular the date as at which open positions are taken to be closed for the purpose of calculating a client equity balance. The definition of “client equity balance” contemplates a notional closing out: “the amount which a firm would be liable... to pay a client...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...” (emphasis added). A fair distribution requires that a single date be taken for all clients. In my judgment, the only appropriate or logical single date is the date of occurrence of the primary pooling event, which triggers entitlements under CASS r.9.7.9R. In the case of GTE, this was February 15, 2008, when the administrators were appointed. Chapter 7 does not contemplate that the interests of clients in the client money held at the date of the primary pooling event will be calculated by reference to the prices at which positions are in fact later closed.

21. It was suggested that the wording of the definition of client equity balance which refers to the deemed closing of open positions “at the closing or settlement prices published by the relevant exchange or other appropriate pricing source” would enable the actual closing out prices to be taken as an “other appropriate pricing source”. In my view, those words have a more limited function and make provision for an alternative source of notional prices as at the relevant time, but do not permit a change to the substantive requirement for a single notional closing of all open positions as at the date of the primary pooling event. Nor, in my view, is it relevant that GTE’s terms and conditions do not provide for an automatic closing out on the appointment of administrators, or that their appointment had no effect on the existence of the contracts between GTE and its clients. Chapter 7 is not concerned with the contractual position, but with defining the rights and interests of clients under the statutory trust of the client money.” The direction accordingly given, set out in [22], was: “For the purposes of distribution pursuant to CASS 7.9.6R, the client money entitlement calculated in accordance with CASS 7.9.7R of each CA Client is to be calculated as at the Time of the Appointment. The Liquidators shall, in respect of each position held by each such client which was closed during the administration or liquidation of the Company, quantify the client money entitlement as though that position was liquidated and closed at the closing or settlement prices published by the relevant exchange or other appropriate pricing source at the Time of the Appointment.” 95. 96. It is clear from the cited passages and the directions given that both the date and method of valuation of client claims were considered and that the hindsight principle was rejected. However, the respondent claimants and creditors did not advance contrary arguments. Full contrary arguments were however advanced to Briggs J when the issue arose at first instance, but not on appeal, in *Lehman*. After referring to *Global Trader*, Briggs J said at [276]: “In *Re Global Trader (No 2)* [2009] EWHC 699 (Ch), [2009]

Bus LR 1327 David Richards J had no hesitation in concluding that the distribution rules required, as a matter of simple interpretation, the calculation and (if necessary) valuation of clients' shares as at the PPE. I have nonetheless been presented with a sustained argument that the distribution date (or, in practice, a date as near to actual distribution of the CMP as possible) constitutes a fairer basis for calculation, essentially because it automatically takes into account events occurring after the PPE which, it is suggested, ought in justice to have a consequence in terms of clients' shares. The types of event in question all arise by way of example from the failure of LBIE, but one or more or even all of them could arise upon the failure of many types of large or sophisticated firm, in particular if it carried on business internationally." He considered the issue and the various submissions made to him at [277] – [324], including many which do not arise on the present application. 97. It was submitted to Briggs J that the hindsight principle should be applied, a submission which he rejected at [312] – [314]: "[312] I must briefly mention an alternative solution propounded by Mr Howe in relation to open positions as at the PPE. Relying on the analysis of Lord Hoffmann in *Wight v Eckhardt Marine GmbH* [2003] UKPC 37, [2004] 2 BCLC 539 at paras [29]-[33], [2004] 1 AC 147, he submitted that the valuation of positions open as at the PPE should, even if conducted as at that date, be carried out with the benefit of hindsight, applying the values obtained on closing as if they were the best evidence of the value of the same positions as at that earlier date.

[313] My conclusion that a PPE valuation is the just application of the principle of pooled fortunes which underlies the distribution rules makes it unnecessary to consider this as a supposed solution to an imaginary injustice. Even if I were wrong however, I do not regard *Wight v Eckhardt* as justifying the use of hindsight for the purposes of a retrospective valuation of an open margined exchange traded position. Lord Hoffmann's analysis was applied to a situation where claims which creditors appeared to have had against an insolvent bank had been, by the time of the adjudication of proofs in the liquidation, overtaken by a statutory scheme whereby the relevant assets and liabilities of the bank had been vested in a newly established bank. Applying an analysis previously used for the valuation of a contingent debt constituted by a policy of insurance on the life of a person living as at the date of the winding-up order, Lord Hoffmann concluded that it was appropriate to take account of the fact that, by the time of adjudication of proof, the supposed creditor had turned out not to be a creditor at all.

[314] That analysis is in my judgment far removed from issues as to the valuation of open exchange traded positions. It is an invariable characteristic of such positions that they are constantly marked to market, for example for the purpose of claiming or repaying variation margin. While LBIE's PPE no doubt occurred between daily valuations of that type, such modest intra-day uncertainty as to the precise value of open positions at the precise moment in time when the administration order was made (which of course occurred at a different time in the business day in the numerous exchanges with which LBIE did business around the world) pale into insignificance compared with an artificial attempt to pretend, by reference to much later closing prices, that the open positions were in truth worth the

amount for which they later closed.”

98. Mr Isaacs submitted that the decisions of Briggs J, and perhaps mine also, was premised on a distribution of client money on the contributions basis and not, as the Supreme Court held, on the claims basis. In my judgment, this does not undermine either decision. Whether hindsight should be used is an issue on either basis and, in fact, the argument on the issue before Briggs J was between parties who were both able to make claims on the contribution basis, but it arises equally, as the present case shows, on the claims basis. 99. I have reached my conclusion in this case independently of the earlier decisions of Briggs J and myself, but it is a conclusion which is consistent with and supported by those decisions.

Conclusion

100. For the reasons given in this judgment, I conclude that the hindsight principle is not applicable to the determination of claims to client money for the purposes of a distribution under CASS 7A.
101. Mr Davis QC, on behalf of the FSA, expressed some misgiving about the terms used in the direction sought by the administrators. He pointed out that neither “mark-to-market” nor “market value” were terms used for those purposes in the relevant provisions. The FSA prefer that the direction reflected the wording of these provisions. I will invite the parties to consider the precise terms of the direction to be given.

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