The Law of Global Custody

Fifth Edition

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BLOOMSBURY

Contents

3.8 For custodians regulated by the Financial Conduct Authority under the Financial Services and Markets Act 2000, the Client Money Rules[1] (CMR) generally apply (broadly) to money received or held from or on behalf of a client in the course of 'designated investment business' or 'MiFID business' as appropriate[2], which in practice will include custody services. The general effect of the CMR is to create a statutory trust over client money[3], thus protecting it from the insolvency of the custodian. However, an exemption is available for relevant banks[4], which will include most bank custodians. The bank exemption relates to money held by an appropriate bank in an account with itself. It requires that the bank gives written notice to the client, which (broadly) warns it that the money is held by it as banker and not as trustee, and will not be held in accordance with the CMR[5].

1 The CMR comprise Chapters 7 and 7A of the Financial Conduct Authority (FCA) Client Assets sourcebook (CASS) in relation to cash held in connection with both non-MiFID business and MiFID business (and also CASS Chapter 5 in relation to cash held in connection with insurance mediation activity, CASS Chapter 11 concerning client money held by a CASS debt management firm, and CASS Chapter 13 which applies to a firm which carries on regulated claims management activity and holds client money). See further in Chapter 7, paras **7.81–7.126** below.

2 See the definitions in the FCA Handbook Glossary. (MiFID refers to Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments – for a brief discussion of the impact of Brexit, see Chapter 1, paras **1.18–1.20**). Designated investment business includes safeguarding and administering investments for the purposes of art 40 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544), as amended (the Regulated Activities Order) provided (broadly) the assets include 'designated investments' as defined in the FCA Handbook Glossary. The definition of 'MiFID business' is quite complex, but very broadly, means investment services or activities regulated by MiFID as implemented in the UK. For further discussion, see Chapter 7.

3 CASS Chapter 7, section 7.17.

4 An 'approved bank' (CASS 7.10.16R(2)) or a 'CRD credit institution' (CASS 7.10.16R(1)) for the purposes of CASS Chapter 7. See Chapter 7, para **7.85** for explanation of these terms.

5 CASS 7.10.19R.

3.9 Some firms offering custody in the UK are not banks, and are not authorised to carry on the business of accepting deposits in the UK[1]. Such custodians are generally not permitted to treat the credit balances of custody cash accounts as debts owed by them to their clients, but instead must hold such credit balances on trust for their clients, for a number of reasons. First, non-banks will not benefit from the debtor/creditor principle as a matter of general law. Second, it is prudent to assume that the operation of a custody cash account otherwise than on a trust basis would amount to accepting deposits. Third, where such firms receive or hold client money in the course of designated investment business or MiFID business, such custodians will generally be subject to the CMR[2]. However, they will not be exempt from the CMR as they are not banks (although custody clients who are either eligible counterparties[3] or professional clients[4] may opt out of client money protection in a non-MiFID context)[5]. In practice, such non-bank custodians usually maintain custody cash accounts as client money accounts with third party banks, and operate those accounts as trustees on their clients' behalf.

1 For the purposes of art 5 of the Regulated Activities Order.

2 CASS 7.10.1R.

3 See the definition in the FCA Handbook Glossary, and the discussion in Chapter 7 para **7.27**.

4 See the definition in the FCA Handbook Glossary, and the discussion in Chapter 7 para **7.27**.

5 CASS 7.10.10R. It should be noted that there is no equivalent of this opt out in CASS Chapter 7 for client money held in the context of MiFID business.

INTERESTS IN SECURITIES, BAILMENT AND TRUST

3.10 Whereas custody clients are generally willing to take custodian credit risk in respect of their cash accounts, it is imperative to ensure that securities credited to client securities accounts are not at risk[1] in the custodian's insolvency[2], or otherwise available to its creditors[3]. The traditional characterisation of the custodian in respect of traditional bearer securities[4] (and other non-cash assets such as bullion[5]) is as the bailee of the client. This characterisation is based on physical possession[6].

1 But see para **3.13** below.

2 'Local laws and regulations should ensure that there is segregation of client assets from the principal assets of their custodian; and no possible claim on client assets in the event of custodian bankruptcy or a similar event': 1995 G30/ISSA Recommendations, recommendation 8. See the G30 website at www.group30.org. See also CASS 6.2.1R (implementing MiFID, art 16(8)) which requires a firm 'when holding safe custody assets belonging to clients' to 'make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the firm's insolvency' and CASS 6.3.4A-1R which requires a firm to 'take the necessary steps to ensure that any client's safe custody assets deposited with a third party are identifiable separately from the applicable assets belonging to the firm and from the applicable assets belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection'.

3 For example, following execution by a judgment creditor.

4 'These bonds are her bonds deposited with Mr Hallett according to the receipt, for safe custody, which would make him, no doubt, an ordinary bailee': *Re Hallett's Estate, Knatchbull v Hallett* (1880) 13 Ch D 696 at 708, per Jessell MR. See also *Kahler v Midland Bank* [1950] AC 24, [1949] 2 All ER 621, HL.

5 See *Dollfus Mieg v Bank of England* [1949] Ch 369, [1949] 1 All ER 946.

6 '"Custody" here clearly relates to the possession or control of the certificates as physical objects': *Swiss Bank Corpn v Lloyds Bank Ltd* [1980] 2 All ER 419 at 431, CA, per Buckley LJ.

3.11 The essence of bailment is the delivery of possession, or physical control (as opposed to the delivery of title, or ownership) by the bailor to the bailee[1]. Thus, the bailee custodian has possession of the physical custody securities, but they remain owned by the client and are unavailable to the creditors of the custodian upon its insolvency.

1 'a person who voluntarily takes another person's goods into his custody holds them as bailee of that person (the owner)': *KH Enterprise v Pioneer Container, The Pioneer Container* [1994] 2 AC 324. See also E G McKendrick 'Bailment' (Ch 36) in H Beale (ed) *Chitty on Contracts* (35th edn, 2023, Sweet & Maxwell/Thomson Reuters), Section 1 – In General, para 36-001: 'Possession of the goods is handed over to someone who is not their owner and that person ("the bailee") is subject to certain obligations in relation to the goods which obligations are owed to their owner ("the bailor"). At a high level of abstraction, it can be said that bailment "denotes a separation of the actual possession of goods from some ultimate or reversionary possessory right"'; and para 36-003 'While it is true that in many, if not most cases, the bailor does consent to the bailee taking possession of the goods, cases can be found in which the bailor clearly does not consent to the bailee taking possession of the goods but a bailment is nevertheless found to exist (where, for example, the finder of a chattel is held to be a bailee notwithstanding the fact that the bailor was wholly unaware of the intervention of the bailee.' And see also the famous classification of bailments in the judgment of Holt CJ in *Coggs v Bernard* (1703) 2 Ld Raym 909:

'there are six sorts of bailments. The first sort of bailment is, a bare naked bailment of goods, delivered by one man to another to keep for the use of the bailor; and this I call a depositum, and it is that sort of bailment which is mentioned in Southcote's case. The second sort is, when goods or chattels that are useful, are lent to a friend gratis, to be used by him; and this is called commodatum, because the thing is to be restored in specie. The third sort is, when goods are left with the bailee to be used by him for hire; this is called locatio et conductio, and the lender is called locator, and the borrower conductor. The fourth sort is, when goods or chattels are delivered to another as a pawn, to be a security to him for money borrowed of him by the bailor; and this is called in Latin vadium, and in English a pawn or a pledge. The fifth sort is when goods or chattels are delivered to be carried, or something is to be done about them for a reward to be paid by the person who delivers them to

the bailee, who is to do the thing about them. The sixth sort is when there is a delivery of goods or chattels to somebody, who is to carry them, or do something about them gratis, without any reward for such his work or carriage, which is this present case.'

3.12 This traditional view of the custody relationship is challenged by computerisation. Chapter 2 argued that, in the electronic environment, the assets in the hands of the custodian in general comprise, not physical instruments, but intangibles. It will be argued below that intangibles cannot be the subject of possession, nor therefore of bailment, and that for these reasons the natural characterisation of the contemporary custody relationship is as a trust.

3.13 A distinction should of course be made between the legal position, and what happens in practice. As was seen with the administration procedures for Lehman Brothers International (Europe), it can take an extremely long time for the administrators to redeliver client securities and client money (even though both are held on trust) to clients. There is however now the special procedure for administration of 'investment banks' (as defined in the Banking Act 2009)[1], namely the Investment Bank Special Administration Regulations 2011[2]. Under these Regulations, it is important to note that the focus is on return of client assets as the administrator has three main objectives, namely to ensure the return of client assets as soon as is reasonably practicable, to ensure timely engagement with market infrastructure bodies and the Bank of England, HM Treasury and the FCA, and to either rescue the investment bank as a going concern or wind it up in the best interests of the creditors. In particular, the administrator is entitled to deal with and return client assets in whatever order the administrator thinks best achieves the return of client assets as soon as is reasonably practicable[3]. In the context of these objectives, the administrator is given the power to set a bar date for submission of claims by clients of the custodian in relation to assets held by the clients with the custodian. Following the setting of a bar date, the administrator is required to return client assets to clients in accordance with the procedure set down by the Investment Bank Special Administration (England and Wales) Rules 2011 (SI 2011/1301). The possibility of the bar date is significant, because as a result of the terms of the Regulations and Rules, the existence of a bar date has the consequence that any client assets returned to a client who made a claim prior to the bar date cannot be recovered by the administrator or any other person, and any client who made a claim prior to the bar date to whom assets have been returned acquires good title to such assets as against a client who made a claim after the bar date. In addition, where claims by clients relate to client assets in an omnibus client account of the custodian, any shortfall of assets in that omnibus account which cannot be remedied will be borne pro rata by all such clients[4], but this is subject to the points in the preceding sentence, therefore any client which makes a claim after the bar date is more likely to suffer loss as a result of a shortfall in an omnibus account. In many respects this is quite a radical approach and treats the property rights of custody clients in much the same way as contractual claims, permitting loss or reduction of property rights where there is a failure to comply with a bar date. Moreover, in order to achieve the objectives under the Regulations, the administrators may make a distribution plan which varies the proprietary rights of clients to client assets, for example if this enables the return of client assets more quickly, subject to court approval[5], therefore the fact that client assets are protected from claims of creditors by being held on trust does not necessarily mean that client assets will be recovered in full by clients in the event of administration under the Regulations.

1 Broadly, entities incorporated in any part of the UK, including England, and providing custody or banking services. Thus the definition does not solely refer to banks.

2 SI 2011/245, as amended.

3 See Investment Bank Special Administration Regulations 2011 (SI 2011/245), reg 10(1) and (2).

4 See Investment Bank Special Administration Regulations 2011 (SI 2011/245), regs 11 and 12.

5 See discussion in *Re Wealthtek LLP (in special administration)* [2024] EWHC 2520 (Ch).

Possession

3.14 The common law recognises both physical (or actual) and legal (or civil) possession. Legal possession has been described as the right to possess. However, the ultimate basis of possession is always fact rather than law because 'the existence of the *de facto* relation of control or apparent dominion [is] required as the foundation of the alleged right'[1]. The concept of constructive possession (discussed in Chapter 1) enables possession to arise without direct physical control[2]. However, constructive possession (like legal possession) is derived from actual possession, and therefore is unlikely to apply to intangible assets[3].

1 Sir Frederick Pollock *An Essay on Possession in the Common Law* (1888, Clarendon Press), p 10.

2 Relevant case law concerning constructive possession is mainly concerned with matters such as keys to rooms and boxes in which physical assets are contained.

3 'Most of the older definitions of bailment seem to require that an overt physical transfer … be present': N E Palmer, *Palmer on Bailment* (2009, 3rd edn, Sweet & Maxwell), p 23, para 1-023. But see generally Chapter 30 'Intangible Property' of the same work, which notes that 'the general law of bailment has developed in many directions' since the conclusion in the second edition of *Palmer on Bailment* that 'bailment is confined to tangible chattels' and 'has no application … to intangible property'. Reference is made in Chapter 30 to 'the difficulty of translating the vocabulary of bailment into situations involving non-material things' but suggests that in principle bailment of intangibles may be a possibility, although 'whether courts are prepared to recognise intangibles as a proper subject of bailment may well depend on the context in which that issue arises'. Consider also *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) in which 'It was common ground between counsel that rights properly classified in English law as a general lien were incapable of application to anything other than tangibles and old-fashioned certificated securities', but Briggs J 'invited the parties to consider whether the time might have come for English law to take a broader view of the matter'. In this case counsel rejected such invitation, but the comments of Briggs J suggests that it is not certain that English courts would reject an argument that a lien (and possibly therefore also bailment) may apply to intangibles. However, see also H Beale (ed) *Chitty on Contracts* (35th edn, 2024, Sweet & Maxwell/Thomson Reuters), Ch 36, para 36-001: 'Possession is … central to bailment: its essence involves the transfer of possession of a chattel to the bailee (or the acquisition of possession by him)' and Michael Bridge, Louise Gullifer, Kelvin Low and Gerard McMeel *The Law of Personal Property* (2022, 3rd edn, Sweet & Maxwell/Thomson Reuters), Ch 12, para 12-005(1): 'First, bailment is said to be founded on possession. Indeed bailment necessarily forms a substantial sub-category of the concept of possession.' As is stated in the Law Commission paper *Digital assets: Final report*, 27 June 2023, para 2.48: 'The legal concept of possession is traditionally limited to tangible things', subject to the exception created by the Electronic Trade Documents Act 2023 (in force from 20 September 2023) pursuant to which possession of an electronic trade document is possible.

3.15 As indicated above, the bailor client retains ownership of the bailed assets, which are not available to the creditors of the bailee in its insolvency. If the computerisation of the securities markets precludes the characterisation of the custodian as bailee, it is necessary to identify another basis on which to protect the client from the credit risk of the custodian. Under English law, the only available alternative is trust. In relation to bailment, 'It is almost universally agreed that no one can become a bailee without possession of a tangible chattel'[1] and 'A bailment passes no general property in the subject chattel and cannot by itself make the bailee owner

of the goods'[2], but in contrast trust property may be intangible since 'any property may be held in trust'[3]. The role of the custodian has evolved far beyond its traditional status as a bailee[4]. The question arises, has it taken the law relating to bailment with it, so that bailment may now relate to intangibles? Or has it left bailment behind so that now the custodian is a trustee? In the absence of direct judicial authority (and given the views expressed by the Law Commission and the UKJT in the context of the discussions of the legal analysis of digital assets[5]), it would be prudent to assume that the custodian, by moving into the electronic environment, has moved into a new legal category[6], and is a trustee[7].

1 But see para **3.14** n 3.

2 N E Palmer, *Palmer on Bailment* (2009, 3rd edn, Sweet & Maxwell), para 1-131, p 134, and para 3-031, p 203.

3 *Snell's Equity* (2020, 34th edn, Sweet & Maxwell), para 21-034. See also Tucker, L, Brightwell, J and Le Poidevin, N (eds) *Lewin on Trusts* (2020, 20th edn, Sweet & Maxwell); and Hayton, D J, *Underhill & Hayton: Law of Trusts and Trustees* (2022, 20th edn, Butterworths).

4 Note that holding as 'agent' is not a further option under English law. Agency is the concept of one person exercising the rights and powers of another (notably, to create contractual relations) on behalf of such person. It is not a concept of holding assets on behalf of another. If an agent holds assets on behalf of its principal, it will hold as bailee or trustee, depending on the circumstances. An agency relationship is a form of fiduciary relationship (see *Parker v McKenna* (1874) 10 Ch App 96) but if an agent holds assets for its principal, cases such as *Burdick v Garrick* (1870) 5 Ch App 233 and *Brown v IRC* [1965] AC 244 indicate that the agent is regarded as holding the assets as trustee. Of course, on the facts the arrangement agreed between agent and principal may be different; for example, it may have been agreed that (in relation to cash) the agent has a contractual obligation to repay but does not hold on trust (*Neste Oy v Lloyds Bank plc* [1983] 2 Lloyd's Rep 658). An interesting question, for which there currently seems to be no clear answer, is whether a custodian holds assets as trustee and carries out its other functions as agent, or the custodian is subject to the duties of a trustee in relation to all of its functions as custodian. Arguably the distinction may be of little significance provided that the custody terms clearly define the extent of the custodian's services, because the custodian is likely to be subject to a high duty of care whether holding assets, or providing services in connection with assets it holds.

5 See the Law Commission paper *Digital assets: Final report*, 27 June 2023, and UKJT 'Legal statement on cryptoassets and smart contracts', November 2019.

6 The bailment analysis will still, of course, be available where the relevant assets are physical instruments and are directly held by the custodian.

Interestingly, the bailment analysis was laid aside in the US in the preparation of the revised Article 8 of the Uniform Commercial Code: 'Relatively early in the drafting process, the decision was reached to eschew the approach of trying to squeeze the analysis of the property interest of a person who holds securities through an intermediary into old legal concepts, such as bailment': J S Rogers *Policy Perspective on Revised UCC Article 8*, UCLALR, June 1996, 1431 at 1496.

7 Custodians who are trustees should not be confused with custodian trustees for the purposes of Public Trustee Act 1906, s 4(3). Statutory custodian trustees hold trust property while leaving the administration and management of the trust to managing trustees. Custodian trustees may be appointed in connection with a debenture issue.

Trust

3.16 A trust is a legal relationship in respect of assets (known as 'trust assets') between (i) one or more persons each known as a trustee and (ii) one or more persons each known as a beneficiary. The trustee holds the trust assets on trust for (ie for the benefit of) the beneficiary. While the trustee has technical or legal ownership of the trust assets, the beneficiary has the economic or beneficial ownership.

3.17 Trust assets are not available to the creditors of the trustee, and are thus protected from the credit risk in respect of the trustee[1]. This insolvency protection

is the reason why it is necessary to characterise the custodian in the electronic environment as a trustee. However, trustee status has other legal consequences including, importantly, the following.

1 In the case of the bankruptcy of an individual, assets held by the individual on trust are excluded from her estate by Insolvency Act 1986, s 283(3)(a). In the case of a corporate insolvency, the authority for the exclusion of trust assets lies in the general principle that only assets owned by the company form part of its estate, as reflected in case law. See, for example, *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567, [1968] 3 WLR 1097, [1968] 3 All ER 651; and *Re Kayford Ltd* [1975] 1 WLR 279, [1975] 1 All ER 604, as well as cases discussed in relation to the allocation question below. (It should of course be noted that, as a practical matter, even where there is no dispute that relevant securities were held by the trustee or custodian for a particular client, as demonstrated in the administration process for Lehman Brothers International (Europe), it may take some time for the insolvency official to identify and redeliver the securities to the client, and in some circumstances an administrator's distribution plan may not reflect the proprietary interests of the beneficiaries – see para **3.13** above.)

3.18 First, under the general law the trustee is subject to a high level of implied fiduciary duties towards the beneficiary, and it follows that the custodian will wish carefully to limit the level of its fiduciary duties by contract[1].

1 For a discussion of contractual limitation of implied fiduciary duty, see Chapter 6.

3.19 Second, English law distinguishes between two types of property interest:

(1) Property interests recognised by the general body of English law (common law) are known as legal interests.

(2) Equitable interests are those interests recognised by the branch of English law known as Equity.

3.20 The law of trusts forms part of the law of equity, and the interests of beneficiaries under a trust in the trust assets are equitable and not legal. On this basis, the property rights in the custody portfolio of the client are equitable. This contrasts with the property rights of a bailor client, which are legal.

3.21 Equitable ownership is as effective as legal ownership in addressing the custodian's credit risk. However, where competing interests in the custody portfolio arise (in the event of fraud or double dealing), the priority of an equitable interest is in some circumstances weaker than that of a legal interest[1].

1 The general principle is that a person acquiring a legal interest in good faith, for value and without notice of a prior equitable interest, takes the disputed asset free from the prior equitable interest.

3.22 Third, a technical requirement arises concerning the establishment of a valid trust; this is discussed in the following paragraphs.

THE ALLOCATION QUESTION[1]

3.23 The allocation question is a technical issue associated with the customary practice among custodians of holding client securities on an unallocated or fungible basis.

1 A large critical literature on this legal question has developed over time. For earlier discussions see D Hayton 'Uncertainty of Subject-Matter of Trusts' (1994) 110 LQR 335; S Worthington 'Sorting out ownership interests in a Bulk: Gifts, Sales and Trusts' [1999] JBL 1; and P Birks 'Mixtures', Chapter 9 in Palmer and McKendrick (eds) *Interests in Goods* (1998, 2nd edn, Lloyd's of London Press). In relation to custody, see J Benjamin 'Custody: an English Law Analysis' (1994) 9 JIBFL 188 and Joanna Benjamin *Interests in Securities* (2000, Oxford University Press), Ch 2.

section B.3, as well as A O Austen-Peters *Custody of Investments* (2000, Oxford University Press), Ch 3. And contrast the concerns expressed in: Financial Markets Law Committee paper 'Issue 3 – Property Interests in Investment Securities', July 2004; Law Commission paper 'The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities – Updated Advice to HM Treasury', May 2007; and Law Commission paper 'The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities – Further Updated Advice to HM Treasury', May 2008; with the conclusions in Law Commission paper *Digital assets: Final report*, 27 June 2023, paras 7.48 to 7.53.

Fungible custody and equivalent redelivery

3.24 Custodial arrangements in respect of securities are in most cases fungible, in the following sense. The custodian aggregates the holdings in securities of a particular issue which it holds for its various clients into one commingled holding ('client holding'). In the case of securities held through a sub-custodian, the client holding will usually be represented in the books of the sub-custodian by a designated client account in the name of the custodian. The client holding in securities held through a settlement system in which the custodian is a participant will usually also be held in a designated client account in the name of the custodian. In cases where a sub-custodian or settlement system is not employed, the client holding in registrable securities will be registered (with a client designation) in the name of the custodian, or its nominee and physical bearer securities will be physically held (and earmarked for clients) by the custodian or its nominee. While the custodian's house position[1] in any security will be segregated[2] from the client holding, there will in general be no record of any allocation between clients in the books of the relevant sub-custodian, settlement system, register or in the physical holding, as the case may be. The only note of the respective entitlements of the individual clients within the client holding will be in the books of the custodian. This arrangement is referred to in the following discussion as 'fungible custody'[3].

1 The house position is any holding by the custodian for its own account, beneficially owned by it.

2 In the sense that the custodian maintains a separate account in its books to record the amount of securities held for the client, and maintains a separate account with its settlement systems and sub-custodians in which are recorded securities held by the custodian for its clients but not for itself. It would be unusual (and impractical) for the custodian's own assets to be segregated from client assets throughout the custody chain, since it is unclear how, for example, the custodian could require a settlement system to maintain with its nominee or depositary a separate account recording only assets held by the custodian for its clients.

3 Reasons for fungible custody include economies of scale, administrative convenience and accounting facility.

3.25 Thus, while it is possible at any time to determine how many of the individual securities comprised in the client holding are attributable to a particular client, it is not possible to determine which ones. A corollary of fungible custody is that the redelivery obligation owed by the custodian to each client is not an obligation to return the assets originally delivered in specie, but merely an obligation to return assets equivalent to those originally delivered.

3.26 During the 1990s a line of case law prompted a debate in the London legal community concerning the impact of fungible custody on the trust relationship between the client and the custodian, which debate is referred to in this chapter as 'the allocation question'. The allocation question concerns the possible legal difficulty in asserting proprietary rights over assets forming part of the commingled pool or bulk, in circumstances where one cannot identify which particular assets within the pool are subject to such purported proprietary rights.

The requirement for allocation

3.27 The allocation question concerns 'the law's insistence that proprietary rights cannot be acquired in fungibles forming an unidentified part of a bulk until they have been separated by some suitable act of appropriation'[1]. This requirement applies both at law and in equity. The common law rule is well established in case law concerning the sale of goods[2], and is given statutory force in Sale of Goods Act 1979, s 16[3]. The rule in equity is based on the principle that a trust cannot be validly established without certainty of subject matter[4]. As Lord Mustill stated in *Re Goldcorp Exchange*:

> 'It makes no difference what the parties intended if what they intend is impossible as is the case with an immediate transfer of [legal and equitable] title to goods whose identity is not yet known.'[5]

1 R M Goode 'Ownership and Obligation in Commercial Transactions' (1987) 103 LQR 433 at 436.

2 See, for example, *Healy v Howlett & Sons* [1917] 1 KB 337; *Re Wait* [1927] 1 Ch 606; *Carlos Federspiel & Co SA v Charles Twigg & Co Ltd* [1957] 1 Lloyd's Rep 240; *Re London Wine Co (Shippers) Ltd* [1986] PCC 121; *Re Goldcorp Exchange Ltd (in receivership)* [1995] 1 AC 74, [1994] 3 WLR 199, [1994] 2 All ER 806; *Glencore International AG v Metro Trading Inc* [2001] Lloyd's Rep 284; and *HM Customs and Excise v Everwine* [2003] All ER (D) 97 (a sale of goods case distinguishing *Re Stapylton Fletcher* (see paras **3.33–3.34** below) to conclude that the claim succeeded regarding the ascertained goods but failed in relation to the unascertained goods).

3 This provides as follows: 'Subject to section 20A below, where there is a contract for the sale of unascertained goods no property in the goods is transferred to the buyer unless and until the goods are ascertained.'

Section 20A (inserted by the Sale of Goods (Amendment) Act 1995, s 1(1) in response to Law Commission paper No 215) provides for title in ex-bulk goods to pass under a tenancy in common, where the purchase price has been paid.

This provision relates to goods, and securities are not goods but (generally) choses in action. Goods are defined in Sale of Goods Act 1979, s 61(1) to exclude 'things in action'.

4 *Knight v Knight* (1840) 3 Beav 148.

5 [1994] 2 All ER 806 at 814.

3.28 Accordingly, a trust cannot be created by the legal owner of a commingled pool of goods who purports to transfer to another person equitable ownership of an unallocated amount of that pool[1].

1 See *Re Wait* [1927] 1 Ch 606. A trust of six of my cases of Château Lafite 1961 where I own 12 cases is void for uncertainty, while a trust of half of my cases of Château Lafite 1961 is valid. But compare *White v Shortall* 9 ITELR 470 (2006, NSWSC) where such an arrangement regarding shares was considered to be effective, following *Hunter v Moss* (see paras **3.37–3.41** below), and see also *Re Lehman Brothers International (Europe) (in administration); Pearson and others v Lehman Brothers Finance SA and other companies* [2010] EWHC 2914 (Ch) and *Re Lehman Brothers International (Europe) (in administration)* [2011] EWCA Civ 1544.

3.29 Because, in fungible custody, the particular securities are not allocated to particular clients, some commentators have argued that the rights of clients may be confined (broadly) to a contractual right against the custodian, arising under the custody agreement, to call for redelivery of securities equivalent to those originally deposited[1]. If this were the position, the implications would be serious, both for the clients and for the custodian. The client's assets would be available to general creditors in the custodian's insolvency. Further, the value of the portfolio as collateral would be reduced[2]. Fortunately, in the light of recent case law, the general view is that fungible custody is compatible with the protection of clients' property rights in the custody portfolio under a trust relationship with the custodian, as discussed below. It is noteworthy that in one of the court cases resulting from the administration of Lehman

Brothers International (Europe)[3], the judge had no difficulty in concluding that assets held under custody terms (in that case as part of a prime brokerage arrangement) were held on trust, even though the term 'trust' was not used in the agreement. The question of certainty of subject matter of the trust was not even raised.

1 See Robert Ryan 'Taking Security Over Investment Portfolios held in Global Custody' [1990] 10 JIBL 404.

2 If the client has no proprietary rights in the custody assets, the value of such collateral to any third party will depend upon the credit risk of the custodian, as well as that of the issuer of the underlying securities.

3 *Re Lehman Brothers International (Europe); Lomas v Rab Market Cycles (Master) Fund Ltd* [2009] EWHC 2545 (Ch).

The cases

3.30 Debate about the allocation question has focused on the following line of cases.

Re London Wine (Shippers) Ltd[1]

3.31 This case concerned a wine importing company to which a receiver had been appointed pursuant to a floating charge in favour of a bank. The company held wine in various warehouses. Most of the wine had been sold to clients who left the wine in the possession of the company's warehouse agent. There was no segregation of any wine crates or cases in favour of clients generally or any particular client. The clients claimed that they had proprietary interests in the wine. The receiver argued that they had merely personal claims against the company for delivery of wine.

1 *Re London Wine (Shippers) Ltd* [1986] PCC 121.

3.32 Judgment was given in favour of the receiver. This was on the basis that there had been no allocation to the clients: proprietary rights could not pass at law for want of allocation or under a trust for want of certainty of subject matter.

Re Stapylton Fletcher Ltd[1]

3.33 The facts of this case were similar to those of *Re London Wine*[2], except that the wine intended for customers was segregated from the trading stock of the company. This difference was held to be crucial[3] and judgment was given in favour of the claimants from the liquidators: 'They will take as tenants in common'[4].

1 *Re Stapylton Fletcher Ltd; Re Ellis, Son & Vidler Ltd* [1994] 1 WLR 1181, [1995] 1 All ER 192.

2 *Re London Wine (Shippers) Ltd* [1986] PCC 121.

3 'I do not regard that decision [in *Re London Wine*] as inevitably governing the case before me. One obvious difference in the present case is the segregation of the wine purchased by the customers in a separate part of the warehouse and the careful maintenance of records within the company. Further as the London Wine Company was free to sell its stock and satisfy the customers from any other available source, there was no ascertainable bulk in that case': per Judge Paul Baker QC at [1994] 1 WLR 1181 at 1194.

4 *Re Stapylton Fletcher Ltd; Re Ellis, Son & Vidler Ltd* [1994] 1 WLR 1181 at 1200.

3.34 As custodians segregate their house positions from client holdings, this case supports a robust approach to the allocation question. However, it would be prudent to

note that, unlike *Re (London Wine), Stapylton Fletcher* related only to legal interests arising in the sale of goods and not to interests under a trust[1].

1 'As I have found for the first four claimants in the case relating to ESV on the basis of the passing of property at law, I do not have to consider the alternative lines of argument based on trusts, fiduciary relationships or other equitable principles in relation to these claims': *Re Stapylton Fletcher Ltd; Re Ellis, Son & Vidler Ltd* [1994] 1 WLR 1181 at 1201.

Re Goldcorp Exchange Ltd (in receivership)[1]

3.35 Goldcorp, a dealer in precious metals, agreed with certain customers ('the unallocated customers') to sell gold to them and to hold it for them on an unallocated basis. It represented that it would set aside and hold a pool of gold sufficient to meet the claims of the unallocated customers, but did not do so. Goldcorp became insolvent and its stock of gold was insufficient to meet the claims of the unallocated customers. In a dispute between receivers appointed pursuant to a floating charge and unallocated customers, judgment was given in favour of the receivers. The claims of the unallocated customers were held to be merely contractual.

1 *Re Goldcorp Exchange Ltd (in receivership)* [1994] 2 All ER 806.

3.36 The judgment distinguishes between 'generic' goods (the source of which is not specified) and 'ex-bulk' goods (which must come from a specified source)[1]. The case for the claimants failed (both at law and in equity) because on the facts *Goldcorp* related to generic goods[2]. If it had been a question of ex-bulk goods, the position might have been different[3]. Thus, it could be argued that, because custodians segregate house position from client holdings, fungible custody falls outside the scope of the decision in *Goldcorp*. However, the judgment remains unclear on this point. Nowhere is it unequivocally stated that if client and house assets had been segregated, the interest of unallocated clients would have been proprietary. As Cooke P understated in the court below, 'it is a difficult area of law'[4].

1 [1994] 2 All ER 806 at 814.

2 [1994] 2 All ER 806 at 814.

3 [1994] 2 All ER 806 at 820.

4 *Liggett v Kensington* [1993] 1 NZLR 257 at 268.

Hunter v Moss[1]

3.37 The custody industry was therefore grateful for the decision in *Hunter v Moss*. The facts of this case were as follows. Moss was the registered holder of 950 shares in a company with 1,000 shares in issue. Moss made a declaration of trust over 5 per cent of the company's issued share capital in favour of Hunter. A valid trust was held by Colin Rimer QC, a deputy judge, to have arisen from the intention to create a trust over 50 of Moss's shares. Moss applied by motion for the judgment to be recalled to deal with the overlooked point that the trust failed for want of certainty of subject matter.

1 *Hunter v Moss* [1993] 1 WLR 934; affd [1994] 1 WLR 452, [1994] 3 All ER 215, CA.

3.38 However, Rimer QC held that, in a trust over intangibles, the requirement for certainty of subject matter does not apply.

'The defendant did not identify any particular 50 shares for the plaintiff because to do so was unnecessary and irrelevant. All 950 of his shares carried identical rights … Any suggested uncertainty as to subject matter appears to me to be theoretical and conceptual rather than real and practical.'[1]

1 [1993] 1 WLR 934 at 946, per Colin Rimer QC (sitting as deputy High Court judge). But in these days of mass production, many tangibles are identical.

3.39 The Court of Appeal dismissed the appeal on the erroneous ground that, just as a person can by will give a specific number of her shares in a particular company, so equally she can declare herself a trustee of 50 of her shares in a particular company. However, on death the settlor is divested of all legal and beneficial ownership of her shares. In life she can only divest herself of the beneficial interest in shares when she has done everything necessary to identify those shares to which she has relinquished beneficial entitlement, namely when she has segregated 50 from those of which she retains beneficial ownership.

3.40 This decision has in the past been treated with some caution in the legal community[1]. In particular, in the Court of Appeal, inter vivos transfers are not distinguished from testamentary transfers. On the particular facts of the case, it was clearly in the interests of justice that a valid trust should be found in the absence of a contractual entitlement. The judgment, which was pragmatic, focused more on the merits of the dispute before the court than the wider principles of equity. There is plenty of authority that certainty of subject matter is essential to a trust over a type of intangible asset, namely cash at bank, which is not adequately dealt with in this case[2].

1 See D Hayton 'Uncertainty of Subject-Matter of Trusts' (1994) 110 LQR 335.

2 See, for example, *Mac-Jordan Construction Ltd v Brookmount Erostin Ltd* [1992] BCLC 350. See also *Re Jartray Developments Ltd* (1982) 22 BLR 134; *Rayack Construction v Lampeter Meat Co Ltd* (1979) 12 BLR 30; *Neste Oy v Lloyds Bank plc* [1983] 2 Lloyd's Rep 658; *Concorde Construction Co Ltd v Colgan Ltd* (1984) 29 BLR 120; *Mills and others v Sportsdirect.com* [2010] EWHC 1072 (Ch). However, these cases may be distinguishable on the basis that they relate to generic and not ex bulk assets.

A purported trust created for value over an unallocated part of a pool of intangibles may create a mere charge if by way of security for payment of a debt: *Swiss Bank v Lloyds Bank* [1979] Ch 548, [1979] 3 WLR 201, [1979] 2 All ER 853; revsd [1982] AC 584, [1980] 3 WLR 457, [1980] 2 All ER 419; affd [1982] AC 584, [1981] 2 WLR 893, [1981] 2 All ER 449. See also *ILG Travel Ltd (in administration)* [1995] 2 BCLC 128 (Ch) and *Edwards and another v Flightline Ltd* [2003] EWCA Civ 63.

3.41 However, in spite of these problems, *Hunter v Moss* has now been followed in *Re Harvard Securities*[1], the Hong Kong case of *CA Pacific*[2], and *White v Shortall*[3], and may appear to be good law. In *Re Lehman Brothers International (Europe) (in administration); Pearson and others v Lehman Brothers Finance SA and other companies* [2010] EWHC 2914 (Ch), the analysis in *Hunter v Moss* was followed and was not disagreed with in the Court of Appeal judgment (*Re Lehman Brothers International (Europe) (in administration)* [2011] EWCA Civ 1544)[4]. Moreover, in later case law, it was stated that 'The legal analysis apparent from the case law is that where the intermediary holds the securities for its account holders in a common pool the individual investor is co-owner in equity with other investors'[5].

1 *Re Harvard Securities (in liquidation)* [1997] 2 BCLC 369. Neither this case nor the Hong Kong case should be cited in court proceedings covered by *Hunter v Moss:* see *Practice Note* [2001] 2 All ER 510.

2 *Re CA Pacific Finance Ltd (in liquidation)* [2000] 1 BCLC 494.

3 9 ITELR 470 (2006, NSWSC). Here Campbell J concluded that the trust declared over 220,000 shares of the total 1.5 million shares held was a declaration of trust over all the shares, deciding that,

'in substance … 220,000 of the shares he held were on trust for the plaintiff, and the rest were on trust for himself', stating that the beneficiary was entitled to a proportion, and describing the trust as 'a trust of a fund … for two different beneficiaries'. The judgment contains considerable emphasis on the nature of shares and the absence of a need to identify specific shares. Nevertheless, it is arguable that this case is not authority for arguing that certainty of subject matter is not necessary for a valid trust, but that on the facts the conclusion was reached that there was a trust over the commingled pool, with each beneficiary having a proportional entitlement (rather than that there was a valid trust over an unidentifiable part of a larger pool).

4 '*Hunter v Moss* has not been without its academic and judicial critics, but its conclusion that there is no objection on the grounds of uncertainty to a trust of part of a shareholding of the trustee has been generally followed, in this country in *Re Harvard Securities* [1997] 2 BCLC 369 [1997] 2 BCLC 369, in Hong Kong in *Re CA Pacific Finance Ltd* [2000] 1 BCLC 494, and in Australia in *White v Shortall* [2006] NSW SC 1379. The difficulty with applying the Court of Appeal's judgment in *Hunter v Moss* to any case not on almost identical facts lies in the absence of any clearly expressed rationale as to how such a trust works in practice. There has not been unanimity among those courts which have followed *Hunter v Moss*, nor among the many academics who have commented upon it, as to the correct approach. The analysis which I have found the most persuasive is that such a trust works by creating a beneficial co-ownership share in the identified fund, rather than in the conceptually much more difficult notion of seeking to identify a particular part of that fund which the beneficiary owns outright. A principal academic advocate for the co-ownership approach is Professor Roy Goode: see for example 'Are Intangible Assets Fungible?' [2003] LMCLQ 379. Among the judicial commentators I have found the analysis of Campbell J in *White v Shortall* (supra) at para 212 to be the most persuasive. My own preference for the co-ownership analysis may be observed in *LBIE v RAB Market Cycles* [2009] EWHC 2545 (Ch), at para 56. I propose to adopt it for the purposes of the analysis which follows.' *Re Lehman Brothers International (Europe) (in administration); Pearson and others v Lehman Brothers Finance SA and other companies* [2010] EWHC 2914 (Ch), Briggs J, at paras 231, 232.

5 *The Persons Identified v Tesco Plc* [2019] EWHC 2858 (Ch), Mr Justice Hildyard, at para 18. See also *North and another v Wilkinson and others* [2018] EWCA Civ 161, at para 21: 'Having regard to *Hunter v Moss* and the *Lehman Brothers* case, there would not be an obstacle to a trust of an undivided share of a holding of securities or of a credit balance on a bank account' (although this should not of course be regarded as suggesting that an undivided share of a commingled holding can be held on trust, if the rest of the holding is not also held on the same trust, and in this case, it was concluded that there was no intention to create a trust over part of a business).

Equitable tenancy in common

3.42 In the authors' view, *Hunter v Moss*[1] may be (roughly) reconciled with *MacJordan*[2] and the other cases referred to above relating to trusts over cash accounts, by taking the current position to be as follows. In fungible custody arrangements, provided client assets are segregated from house assets, the requirement for certainty of subject matter is not inapplicable; however, it is automatically satisfied by an implied co-ownership arrangement, whereby the custodian holds the client holding under a single trust for all clients to whose accounts it has credited the relevant security, as equitable tenants in common[3]. This analysis is consistent with the decision in *Re Stapylton Fletcher*[4], but not with that in *CA Pacific*[5]. It is submitted that the latter is unreliable. It is also submitted that it should not be assumed that clients enjoy property rights unless the client holding is segregated from the house position[6]. Thus, in collateral arrangements where the custodian is permitted to credit client securities to its house account[7], it should be assumed that the client's rights are merely contractual, so that she takes the credit risk of the custodian[8], unless the custodian holds on trust for both itself and its client(s)[9].

1 [1993] 1 WLR 934; affd [1994] 1 WLR 452, [1994] 3 All ER 215, CA.

2 *Mac-Jordan Construction Ltd v Brookmount Erostin Ltd* [1992] BCLC 350.

3 See also the Law Commission paper *Digital Assets: Final report*, 27 June 2023, para 7.55: 'We conclude that the best way to understand the interests of beneficiaries under such trusts are as rights of co-ownership in an equitable tenancy in common.'

4 *Re Stapylton Fletcher Ltd; Re Ellis, Son & Vidler Ltd* [1994] 1 WLR 1181, [1995] 1 All ER 192.

5 *Re CA Pacific Finance Ltd (in liquidation)* [2000] 1 BCLC 494. In this case it was concluded that 'the fungible nature of such securities permits the client to retain a proprietary interest in them without the need for appropriation' but that it was 'difficult to infer a tenancy-in-common'. (Although note that *CA Pacific* was cited with (apparent) approval in the judgment in *Re Lehman Brothers International (Europe) (in administration); Pearson and others v Lehman Brothers Finance SA and other companies* [2010] EWHC 2914 (Ch), see paras 231 and 233.)

6 Without such segregation, the assets would be generic and not ex bulk, and therefore outside the scope of *Re Stapylton Fletcher* and related cases.

7 For example, under prime brokerage arrangements.

8 See *Re Lehman Brothers International (Europe); Lomas v Rab Market Cycles (Master) Fund Ltd* [2009] EWHC 2545 (Ch), at para 54 'it is well established, in particular in commercial relationships, that the presence or absence of an obligation on B (the recipient) to keep the property separate from its own property is a powerful indicator of the presence or absence of a relationship of trustee and beneficiary between B and A. By contrast, the existence of a right in B to mix the fungible property of one beneficiary with the fungible property of another beneficiary in a single fund has never been a powerful contra-indication against the existence of a relationship of trustee and beneficiary between B and A.'. And see J Hudson, B McFarlane and C Mitchell *Hayton, McFarlane and Mitchell on Equity and Trusts* (2022, 15th edn, Sweet & Maxwell), paras 16-147, 16-148 and 16-150 (the context is the discussion of *Quistclose* trusts of money, but the concepts are of wider application):

> 'There must be an intention to create a trust on the part of the transferor. This is an objective question. It means that the transferor must have intended to enter into arrangements which, viewed objectively, have the effect in law of creating a trust. In this respect, Quistclose-type trusts are no different from any other trusts. … where it is not demonstrated that money apparently advanced by way of loan is not to be at the free disposal of the transferee, the ordinary consequence is that the money becomes the property of the transferee, who is free to apply it as he chooses, leaving the lender at risk of his insolvency. This is the true default position, in which the transfer of the legal title carries with it the beneficial interest.'

9 As in *White v Shortall* 9 ITELR 470 (2006, NSWSC).

Two lines of cases

3.43 An advantage of the above 'tenancy in common' approach is that it reconciles the cases relating to the allocation question with another line of cases, relating to mixing.

3.44 The issue under consideration in the allocation cases discussed above was the acquisition, by the purchasers, of proprietary interests in assets forming part of a fungible pool. In all these cases the mixing of the whole *antedates* the possible ownership of part.

3.45 Another line of cases establishes the principle, based on Roman law, that where the goods of different owners are mixed together so that they cannot be separated, the owners will hold the commingled goods as tenants in common[1]. In these cases, the mixing of the whole *predates* the possible ownership of part. These cases concern the preservation of existing proprietary rights, as opposed to the creation of new ones.

1 See *Buckley v Gross* (1863) 3 B & S 566, 122 ER 213; *Spence v Union Marine Insurance Co Ltd* (1868) LR 3 CP 427; *Indian Oil Corpn Ltd v Greenstone Shipping SA, The Ypatianna* [1988] QB 345, [1987] 3 WLR 869, [1987] 3 All ER 893; *Glencore International AG v Metro Trading Inc* [2001] 1 Lloyd's Rep 284; and *ABFA Commodities Trading Ltd v Petraco Oil Co SA* [2024] EWHC 147 (Comm).

3.46 In practice, the operational complexities of settlement are such that it may not be possible to determine which part of a client's custody portfolio is governed by which line of case law. It is therefore helpful to conclude that such determination is unnecessary, on the basis that the position will be the same in any event, and that the client enjoys property rights under an equitable tenancy in common.

Conclusions

3.47 In relation to the custody securities portfolio, it is necessary to protect the client from the credit risk of the custodian. The traditional legal technique for achieving this, by characterising the custodian as a bailee, is ineffective in an electronic environment. It is therefore necessary to establish a trust. With fungible custody, the lack of allocation between any particular client and particular underlying securities raises the allocation question: is there sufficient certainty of subject matter in order to establish a valid trust? As discussed above, the natural answer to the allocation problem is co-ownership. Rather than seek to identify a trust in favour of each client over their unallocated portion of the client securities, one may identify one global trust over all the client securities of a particular type in favour of all relevant clients as tenants in common[1].

1 A separate tenancy in common exists in relation to each type of security from time to time comprised in clients' portfolios. This is because, in practice, it will not be the case that each client's portfolio includes the same range of securities in the same proportions. A necessary feature of a tenancy in common is unity of possession. Martin Dixon, Janet Bignell and Nick Hopkins *Megarry and Wade The Law of Real Property* (2024, 10th edn, Sweet & Maxwell), Ch 12, Part 1 'Joint Tenancy and Tenancy in Common'.

This multiplication of tenancies in common should not create any administrative difficulty, because their existence is notional and automatic, and does not require any practical step to be taken.

3.48 Another requirement under English law for a valid trust is certainty of intention. Given that English law looks at the substance of the intention of the parties, rather than simply the title of the document, the absence of any reference to a trust in a custody agreement is not an obstacle to the custodian holding the custody assets on trust. This was made clear in a case arising out of the administration of Lehman Brothers International (Europe)[1] where the judge concluded there was a trust as a result of a clear intention in the agreement that the client retained ownership of the relevant securities[2].

1 In *Re Lehman Brothers International (Europe); Lomas v Rab Market Cycles (Master) Fund Ltd* [2009] EWHC 2545 (Ch).

2 In this case, Briggs J stated that 'Where an entity ("A") transfers legal title to property to another ("B") pursuant to a detailed written agreement, the question whether A has retained some proprietary or beneficial interest in the property transferred depends upon the parties' deemed mutual intention, on the true interpretation of that agreement'. Based on 'the parties … use of the words "custody" and "custodian", and by the phrases … "belong to the Counterparty" and "do not belong to the Prime Broker"' Briggs J concluded that the parties had 'used the clearest language to display their intention that securities held by the Prime Broker for the time being continue to belong beneficially to the Counterparty'. Moreover, even where securities were held in an omnibus account so that 'the proprietary interest of any particular Counterparty is to a rateable share in the fungible account rather than in particular securities in that account', he considered that 'there is no reason … why that interest should not be recognised as proprietary, or that the obligations of the account holder (be it as custodian or sub-custodian) are those of a trustee.' Briggs J also stated that he regarded the wording quoted from the agreement and the provisions prohibiting the mixing of client securities with securities of the custodian or sub-custodian 'as powerful indicators in favour of the recognition of the creation of a trustee/beneficial relationship between the Prime Broker and Counterparty in relation to securities'. In addition, in *Re Lehman Brothers International (Europe)* [2009] EWCA Civ 1161, where the Court of Appeal refused to allow a scheme of arrangement which would vary the rights of beneficiaries under a trust, the trusts in question were established under prime broker agreements and custody agreements, and there was no suggestion that the rights of clients under such agreements to assets held for them by Lehmans were other than as beneficial interests under a trust.

3.49 In the interests of legal clarity, it may be prudent to include express wording in the custody documentation to confirm the existence of such equitable tenancies in common among the custody clients over the commingled client holdings.

SHORTFALLS

3.50 Even if a trust or similar arrangement is recognised in the insolvency of the custodian, the client will still suffer loss if there is a shortfall in the securities held for it by the custodian.

> 'Shortfalls in custodial holdings may develop for a number of reasons, including the failure of trades to settle as anticipated, poor accounting controls, or intentional fraud. The shortfalls may be temporary or long-standing. Allocation of the risk of loss from a shortfall will vary depending on the circumstances under which the shortfall arose. Of course, if the custodian is solvent, no real problems arise; it may either replace the missing securities, or pay damages, or both. However, if the custodian is insolvent, or the shortfall arises from fraud or insolvency on the part of a sub-custodian or CSD, the investor's risk of loss may be severe.'[1]

1 Bank for International Settlements *Cross-Border Securities Settlement* (May 1995, Basle), p 20.

Shortfalls and commingled accounts

3.51 A risk associated with commingled custody accounts is that shortfalls attributable to the business of one client may be borne by other clients sharing the account. Where client-specific segregation is not offered, therefore, clients may wish to know whether the custodian engages in practices which heighten the risk of shortfall.

3.52 One source of shortfall risk is presented by security interests in favour of intermediaries in the global custody chain, such as sub-custodians and settlement systems. For example, if a global custodian becomes insolvent, a sub-custodian may enforce a lien over the client assets it holds for the global custodian in respect of unpaid fees[1].

1 The possibility of this is now limited where the custodian is regulated by the FCA by the restriction of the grant of liens and similar interests of over client securities, and the use of a client's assets for the account of the firm or any other person (see Chapter 7, paras **7.62–7.65**). The FCA Conduct of Business Rules (COBS) still require a custodian to inform (but not agree in writing with) the client (for all categories of client) of 'the existence and terms of any security interest or lien which the firm has or may have over the client's designated investments or client money, or any right of set-off it holds in relation to the client's designated investments or client money' and that 'a depositary may have a security interest or lien over, or right of set-off in relation to those instruments or money' (COBS 6.1.7R(2) and see similar requirement for MiFID business in COBS 6.1ZA.9UK, 49(6)). Also, the CASS rules require a custodian to obtain 'express prior consent' from clients to the use of such client's assets for the benefit of other clients, for example in the context of settlement from an omnibus client account (CASS 6.4). See further Chapter 7, para **7.70**).

3.53 A further source of potential shortfall risk is the deduction of liquidator's costs. The case of *Berkeley Applegate (Investment Consultants) Ltd*[1] established the principle that, where the assets of the insolvent company are insufficient to meet the liquidator's costs in administering property held on trust by the company for its clients, the court has discretion to award those costs out of the trust assets[2]. This principle may pose a threat to the assets of custody clients where the custodian does not have substantial assets of its own, and where adequate records of the custody business have not been kept, so that significant work is required to clarify the entitlements of clients.

1 [1988] 3 All ER 71.

2 [1988] 3 All ER 71 at 76, 82. See also *Re Sports Betting Media Ltd* [2007] All ER (D) 123, *Eason and another v Wong* [2017] EWHC 209 (Ch) and *Re Wealthtek LLP (in special administration)* [2024] EWHC 3050 (Ch).

3.54 Shortfalls may arise as a result of contractual settlement, a service offered by some global custodians in relation to cash or (more rarely) securities. The custodian agrees that, where moneys or securities are due to be received under a trade, those assets will be credited to the client's account on the date agreed for settlement with the counterparty, whether or not they are actually received on that date by the custodian. The custodian reserves the right to reverse the credit entry if the assets do not arrive within a reasonable period[1]. Contractual settlement amounts to the lending of cash and/or securities[2]. Where contractual settlement is offered in connection with a commingled securities account, the following risk arises. If a purchase of bonds is contractually settled, the client is free to sell them to a third party. If such a sale leaves the client's holding at zero and the original trade fails, the custodian cannot reverse the credit entry without causing a shortfall. Further, as the contractual settlement of securities amounts to securities lending, the question arises, from whom is the client borrowing? It will only be borrowing from the custodian if the custodian transfers new securities into the commingled account to support the transaction. If the custodian does not do this, the client is borrowing securities from the other clients of the custodian, possibly without their consent or knowledge. Such arrangements may well be unlawful and in breach of CASS requirements.

1 Custodians only offer contractual settlement in markets where they are confident of timely settlement.

2 This raises issues of authority to lend and borrow such assets, as well as taxation issues.

Allocation of shortfall

3.55 Where there is a shortfall in the pooled client securities account of an insolvent custodian, the question arises how the shortfall will be borne by the respective clients. Where the account has been very active, it seems likely that the loss would be borne pro rata among all the affected clients in order to 'apportion a common misfortune'[1]. Interestingly, the risk warnings required to be given to commingled clients by the Financial Services Authority (FSA) under the old FSA rules applicable in a non-MiFID context assumed that shortfalls would (or might) be pro rated[2]. Another possibility is that, in an administration under the Investment Bank Special Administration Regulations 2011, the available records of the insolvent entity may be so defective that it is impractical, or at the least very expensive, and time-consuming to seek to identify the exact entitlement of each client and then allocate the shortfall on a pro rata basis, so that the administrator exercises its power to make a distribution of client assets to clients in a manner which is not in accordance with the clients' proprietary rights but is a pragmatic solution[3]. However, the position would be less clear in the unlikely event that the account was inactive, so that as a matter evidence it was relatively easy to identify the transactions which had caused the shortfall. In such a case, the courts might apply the traditional tracing rules to attribute the 'missing' securities to a particular client or clients[4].

1 See *Barlow Clowes International v Vaughan* [1992] 4 All ER 22. See also *Russell-Cooke Trust Co and another v Richard Prentis and Co Ltd* [2002] EWHC 2227 (Ch) where the same principle was applied to some assets, but for assets considered to have been specifically allocated to specific and identified clients Lindsay J rejected the 'proposition that, wherever there is shared common misfortune, clearly discernible separate property rights are to be surrendered or overridden. Investors may, so to speak, be in the same boat but that, of itself, does not require anyone to give up the life jacket which he is already plainly wearing'.

2 See old CASS 2.3.3G:

> 'When explaining the meaning of pooling to a retail client, firms are expected to advise the retail client that … in the event of an unreconcilable shortfall after the failure [note – the term 'failure' is