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Introduction

1.1 In May 2009, the discussion paper *Developing effective resolution arrangements for investment banks* was published, to assess the lessons that could be learnt from the failure of Lehman Brothers to improve the current regulatory and insolvency regime. This discussion paper was followed by a full consultation paper, *Establishing resolution arrangements for investment banks*, published on16 December 2009 (henceforth referred to in this document as 'the December consultation paper').

1.2 The December consultation paper, set out detailed proposals to enable the effective resolution of a failed investment firm. The proposals consulted on included market, regulatory and legislative actions. Comments were requested by 16 March 2010.

In total, 31 responses to the consultation were received. Written responses – excluding those for which confidentiality was requested – can be found on the Treasury website at the following address: www.hm-treasury.gov.uk/consult_investment_banks2.htm. Since the publication of the December consultation document, the Investment Banking Advisory Panel has met to discuss the December proposals, and a number of the Panel's working group meetings have also been held. The Government is grateful to the large number of organisations and individuals took the time to respond to the consultation, and participated in the Advisory Panel and its working groups.

1.3 This paper summarises the responses received to the December consultation paper. Responses to the questions from that paper are worked through in turn, chapter by chapter. The Government is now considering these responses (and the input from the Advisory Panel) and will publish its conclusions and further proposals in September 2010.

Responses to the introductory chapter

1.4 The key issue for consultation raised in the introductory chapter of the December consultation paper related to the scope of the proposals, which was defined in terms of "investment firms" as defined in the Markets in Financial Instruments Directive (MiFID).

> 1. Do you have any comments on the proposed definitions of investment firm for the purposes of this work?

1.5 Many of those who responded commented that the proposed definition of investment firms should not be used to determine the scope of all the investment banking resolution measures set out in the December paper, particularly those relating to managed wind-down set out in chapter 3.

1.6 Respondents warned that the broad scope would disproportionately impact on smaller firms whose business models were simpler than Lehman Brothers. Some respondents argued that as the measures were aimed at larger, more systemic investment firms, a distinction could be made between the different types of firms, such as asset managers and investment banks.

Responses to chapter 2: enabling an orderly resolution

1.8 The questions in this chapter related to proposals for a new special administration regime (SAR) for failed investment firms. The proposals are intended to ensure that the administration of a failed firm is conducted with due regard to financial stability and the proper functioning of markets, as well as with reference to the need for the speedy recovery of assets for clients, and the reconciliation of counterparty positions.

> 2. Do you agree with the Government's proposals for special administration objectives and associated policy measures? Are there any supporting levers not considered that would be critical for the effective functioning of the special objectives?

1.9 The majority of respondents indicated that they broadly support the special administration objectives (SAOs) as long as they are flexible and procedural. It was generally felt that no objective should be given a statutory priority over others and that the administrators should have the flexibility to prioritise the objectives as required by the particular circumstances.

1.10 In addition, respondents noted that, unlike the special resolution regime for deposit takers under the Banking Act 2009, whereby a transfer can be made by law, a transfer of business made to a purchaser before or in the course of the SAR must be by means of a commercial agreement. Necessarily, such a commercial agreement would address issues regarding the supply of services and facilities. Therefore, to impose a duty on the administrator, over and above terms agreed commercially, could undermine his or her bargaining power and be an unnecessary complication and source of uncertainty.

> 3. What are your views on introducing a limited restriction to the liability of the administrator, restricting creditors from taking action in certain circumstances, related to administrators' actions in pursuit of the SAOs?

1.11 There was mixed support from respondents for amending administrator liability. Some respondents argued that administrators already have enough defence against personal liability and noted that other special administration regimes do not have similar protections for administrators. Other respondents, however, thought this could be a useful measure to ensure that administrators are protected while they act on their objectives in an efficient manner. Most of the concerns raised were against a complete restriction on liability where the administrators are acting in good faith, noting that a complete restriction could damage market perceptions that the administrators are accountable and are working with due care.

> 4. What are your views on the suggestion that the personal liability of administrators should not be greater than that of the company's directors before the company went into insolvency?

1.12 The majority of respondents felt that no changes should be made in this respect. It was generally felt that if this is a change worth considering, it should apply not only to the SAR, but is a broader issue to be discussed in the context of general insolvency law.

> 5. Do you agree with the Government's approach to the court process for clarification around liability? What kind of expedited court process could be considered? Should one be required?

1.13 There was a mixed response from respondents to the expedited court procedure proposal. Some were of the view that this kind of process could help speed up the resolution of a systemic firm, while others argued that the courts are already extremely responsive to these types of requests from administrators, and that an expedited court process is unnecessary.

6. Is there any other approach the Government could consider with respect to the modification of administrator liability for the purposes of the special administration regime for investment firms?

1.14 Respondents concluded that there are no other proposals around liability that the Government needs to consider.

7. Do you agree with the Government's approach in providing a special defence for directors of investment firms against actions taken by administrators and others, to enable directors to implement resolution plan actions in the interests of the firms' creditors and of general financial stability? What specific modifications could the Government consider applying?

1.15 The majority of respondents felt that no significant modifications should be made to director liability; however, respondents also noted that if the Authorities require the directors of a firm to take certain actions, the directors should not then be held liable for them.

8. Do you agree with the proposals for the initiation and scope of the special administration regime for investment firms and its interaction with the provisions of Part 2 of the Banking Act 2009, as discussed in Box 2A?

1.16 Most respondents queried the need for any special conditions (in addition to those already set out in general insolvency law) to be attached to the initiation of the SAR. On a close related point, respondent also indicated that the new regime should become the norm for investment firms that fall within the proposed scope. It was suggested that special conditions would reduce clarity over whether an investment firm would end up in the SAR or not.

1.17 The majority of respondents stated that they would welcome more detail from the Government on how both the Bank Insolvency Procedure and the Bank Administration Procedure in the Banking Act 2009 would interact with the SAR and it special administration objectives. Many respondents provided helpful comments on how this interaction could work, while others preferred to wait to comment on the draft legislation.

9. Is there a case to consider provisions in the special administration regime for investment firms in relation to new financing? The Government also welcomes feedback on the potential legislative or other hurdles to an investment firm obtaining additional funding from third parties in the period immediately before insolvency to close out its positions. Are there other issues or options in relation to intra-day support that the Government might need to consider?

1.18 Respondents generally opposed any legislative measures to further facilitate debt financing by third parties to the insolvent firm. It was noted that the Insolvency Service has consulted on this and reached the conclusion that it was not a suitable proposal to take forward.

10. The Government considers the costs to market participants of implementing the special administration regime, with provisions for special administration objectives, liability of insolvency professionals and directors, and possible legislative changes for intra-day support to be negligible. Do you agree with the cost suggested? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

1.19 Those who responded to this question tended to agree that the costs of implementing the special administration regime would be negligible although it was pointed out that there could be costs associated with any risk assessment in relation to the new regime that may need to be undertaken by counterparties of a UK investment firm. This could involve (for example) obtaining legal opinions regarding the impact of the new process on counterparty rights and reviewing documentation.

11. The Government would welcome views on the types of communications methods market participants would prefer and the type of information they would like to receive from the authorities in case of an investment firm failure.

1.20 Respondents were in favour of more efficient and coordinated communication from the Authorities in the event of another investment firm failure. It was suggested that any communication should set out:

- a clear statement on the role of the Authorities;
- the engagement of the Authorities with the investment firm and its wider group whether in or outside the UK; and
- a named point of contact at the relevant Authorities.

12. The Government considers the costs to market participants of a resource centre providing best practice guidance to administrators, and plans for co-ordinated market communication in the event of investment firm failure to be negligible, as these would require no market action. Do you agree with the cost suggested? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

1.21 Of those responding to this question, few questioned the assumptions on costs. However, most then qualified their responses by indicating their opposition to the resource centre measure as a whole.

13. Do you agree with the Government's proposal for international entities not subject to these proposals to be able to 'opt in' to the firm-level resolution regime?

1.22 Respondents were generally not opposed to the idea of allowing branches of overseas firms to opt into the SAR, but thought that it would be unlikely ever to happen in practice as the home state would desire to have the branch under its control. Respondents generally thought that this was more an issue of disclosure, so that investors understand into which insolvency regime a firm will be entered.

14. Are there any other specific issues in relation to cross-border investment firms that need to be addressed?

1.23 In replying to this question, most respondents recognised that enhanced international cooperation between regulators in respect of resolution and insolvency proceedings is crucial. Respondents highlighted the importance of establishing how the current proposals will work in relation to cross-border investment firms, particularly as the potential divergence of national regulatory regimes and markets means that individual jurisdictions may experience difficulties in resolving the problems of defaulting cross-border investment firms. Respondents also indicated that continuity of service is an important aspect of resolving cross-border firms.

15. The Government welcomes views on the extent to which the package of measures will contribute to achieving the effective resolution of investment firms. Do you believe there is a case for the measures to be further enhanced by a special resolution regime for investment firms?

1.24 There were differing opinions from respondents on whether the proposals went far enough. Some believed that special resolution type tools should be developed for investment firms and could be of benefit in the future, while others believed that the combination of the SAR and the other proposals put forth in the December paper went far enough in addressing the issues raised.

Responses to chapter 3: requiring firms to manage failure

1.25 The proposals in chapter 3 of the December consultation paper concerned new regulatory requirements under which firms would take a leading role in managing for their own failure. While the Government will outline in more detail its views on these proposals in the paper for publication in September 2010, the Government also notes that it will be for the Financial Services Authority (FSA) to take forward these proposals, if appropriate, subject to its own cost benefit analysis.

16. Do you have views on the coverage or detail of the business resolution officer's (BRO) responsibilities? Are these consistent or compatible with existing templates for the corporate governance structure of firms?

1.26 There was general agreement on the broad scope of responsibilities outlined in the December consultation paper, but some respondents expressed concern that the duties of the BRO should not be too prescriptive and burdensome, taking into account existing compliance requirements. There were suggestions, therefore, that the BRO's role should be limited to one of coordination, or of overseeing the preparation and maintenance of resolution plans and Business Information Packs (BIPs). Some respondents were of the view that the BRO's role should terminate when an administrator is appointed, unless the administrator allows the role to continue.

17. Do you agree with the basic policy of establishing a role for BROs in investment firms and do you believe that this is an effective way for the FSA to ensure that the firm implements resolution actions effectively?

1.27 A majority of respondents supported a role for BROs. Some respondents were of the view that for smaller, less complex firms, the costs would outweigh the benefits. Some suggested that the BRO is likely to require a supporting team to carry out their duties, for example, a business resolution committee, comprising representatives of key functions.

18. What are your views on the nature of appointment of the BRO? Do you agree with the Government's suggested approach for implementing this policy, for example, the role being additional to a Board member's pre-existing duties and part of the FSA's Approved Persons regime?

1.28 Respondents sought clarity on the Board's responsibility and the interaction of the BRO's role with that of other officers, suggesting that it is the firm and not the BRO that should bear sanctions for failings in resolution planning. Some respondents pointed to a possible conflict of interest in the BRO's duties between those towards the firm as a going concern, and those towards resolution planning.

1.29 Respondents also favoured the role of the BRO being part of the Approved Persons regime.

19. Discussions with stakeholders indicate that the additional responsibilities of a Board-level officer as a BRO would require 10-20 per cent of their time on an annual basis or £100,000 to £200,000 per annum. Do you agree with the cost suggested? If not, please provide an estimate of costs that are likely to occur, stating your assumptions.

1.30 Views on costs differed among respondents. Some believed that the BRO would not need to devote as much as 10 per cent of their time for the role, because the major time commitment would be in maintaining BIPs, and this function would be likely to be carried out by an executive below board level. Others felt costs might exceed the range shown in the paper, depending on the intensity of engagement with the FSA and the size and complexity of the firm.

20. Do you agree that investment firm resolution plans can consist of internal actions followed by market-facing actions as proposed above?

1.31 Some respondents agreed with the principle of requiring firms to plan in advance for resolution actions, as an extension of firms' usual contingency planning practices. However, the majority of respondents highlighted potential obstacles that might prevent the plans from being implemented effectively, and as envisaged, at the time of resolution. One respondent suggested that supervisors' understanding of, and engagement with, the institution would be likely to be of greater use than a formal wind-down plan.

21. What are the obstacles to implementing investment firm resolution plans? What policies could the Government consider to address these, if any?

1.32 Some of the main difficulties with implementing resolution actions (internal and external) immediately prior to insolvency highlighted by respondents were:

- the risk in terms of market confidence of creating a visible 'hard' trigger for implementation of resolution plans: respondents argued that resolution plans should be internalised as part of the firm's corporate governance processes in order to limit the possibility of negative market reaction were such plans to be implemented;
- the risk of creating creditor preference: when external resolution actions are implemented, there is a risk that this could create preference for one group of creditors over another;
- the trigger for resolution actions: it would be extremely difficult to make a judgement about when the firm should start implementing resolution actions, particularly during phase one;
- the availability of liquidity: market-facing resolution actions would require the firm to have access to liquidity, for example, to continue to meet collateral and margin calls. Knock-on effects from internal phase one resolution actions might also create the need for additional liquidity; and
- a conflict of interest: if the role of senior management in implementing resolution actions is not clearly defined, they might face conflicts of interest between working for the interests of the institution and its creditors, versus working to maintain financial stability.

22. Initial discussions with stakeholders indicate that for the prime brokerage business, initial costs of setting up investment firm resolution plans could be about £1-£3 million, with a team of about ten people from different parts of the business working on them. The prime brokerage business may incur an additional £0.5-£1 million per year for continually updating the resolution plans, with a team of three people working on them.

Stakeholders have suggested that costs for the entire investment banking business, including prime brokerage, would be approximately five times the costs for the prime brokerage business mentioned above; £5-15 million one-off costs, and £2.5-£5 million annual costs.

There may also be ongoing benefits to the investment banking business from having in place continually updated resolution plans. These may include, for example, increased operational efficiency from identification of interdependencies between business units. However, these are not taken into account here, as it would be challenging to estimate the effect of resolution plans separate from that of other factors.

These costs will ultimately depend on the final proposals put forward by the FSA. As discussed above, the FSA will be conducting a full cost-benefit analysis of its proposals.

Based on the proposals for resolution plans, do you agree with the costs for the prime brokerage business? If not, please provide a summary of the costs that are likely to occur, stating your assumptions.

Based on the proposals for investment firm resolution plans, do you agree with the estimated costs for the prime brokerage business?

23. What resources do you expect the entire investment banking business of the firm to spend on investment firm resolution plan implementation? Costs would include those related to: (a) the designing and setting up of investment firm resolution plans in collaboration with the FSA; (b) the ongoing audit and update of investment firm resolution plans and their inclusion in the firm's corporate governance activities; and (c) the additional resources required to implement investment firm resolution plans in a distress situation, if any.

1.33 Responses to these questions suggested that costs would vary greatly depending on the exact requirement, and on the size and complexity of the firm. Respondents noted that the proposals would be likely to require external resources, increasing costs. This could lead to competitiveness issues, as branches of EEA firms operating in the UK under a 'passport' would not be required to prepare such plans.

24. Do you agree that business information packs (BIPs) will be useful to administrators and will fulfil the Government's objectives for a managed wind-down of investment firms?

1.34 Regarding the kind of information BIPs should contain, some respondents felt that the role of BIPs should be simply to provide administrators with a roadmap of the business and location of data and records, rather than up-to-date information on actual trading positions and exposures. Others felt BIPs would need to be live documents, regularly recording the firm's trading positions and details on client assets. According to some responses, for a BIP to be useful, it should be treated as part of a resolution plan, rather than be treated on a stand-alone basis.

1.35 Some respondents were against a prescriptive approach to specifying components of the BIP, instead highlighting the need for BIPs to be flexible and proportionate to a firm's activities and risks. Respondents pointed to the need to consider existing FSA rules, and firms' crisis management mechanisms, when introducing BIP requirements, to avoid overlaps and unnecessary costs.

25. Initial discussions with stakeholders indicate that for the prime brokerage business, initial costs of setting up BIPs would be similar to those of investment firm resolution plans, at about £1-£3 million, with a team of about ten people from different parts of the business working on them. The prime brokerage business is likely to incur an additional £0.5-£1 million per year for continually updating the BIPs, with a team of three people working on them.

Stakeholders have suggested that costs for the entire investment banking business, including prime brokerage, would be approximately five times the costs for the prime brokerage business mentioned above; £5-15 million one-off costs, and £2.5-£5 million annual costs.

Based on the proposals for BIPs outlined here, do you agree with the estimated costs for the prime brokerage business?

1.36 None of the respondents made specific comments on the cost estimates in the paper, pending further details on the proposal and on scope. However, respondents did suggest that without a lighter application of BIP requirements to smaller, simpler firms, costs on such firms would be disproportionate to the risks posed by them.

26. What resources do you expect the entire investment banking business to spend on BIPs implementation? Costs would include those related to: (a) the designing and setting up of BIPs in collaboration with the FSA; (b) the ongoing audit and update of BIPs and their inclusion in the firm's corporate governance activities; and (c) the additional resources required to supplement the BIPs in a distress situation.

1.37 Respondents pointed out that the designing and setting up of resolution plans may require firms to engage external advisers and consultants, or employ specialists to take ownership of plans, including their audit and maintenance. Some have argued that additional costs could arise if the BIP were to be introduced as a separate stand-alone document, rather than as an integral part of an investment firm's broader resolution plan: If the BIP and resolution plan were treated as separate products then, overall, it could make the BIPs and the resolution plans difficult to implement and maintain in unison with one another. Respondents suggested that BIPs could act as a part of a resolution plan which would signpost the location of data, records, and key personnel.

27. The Government would like views on what incentives and disincentives to retain employees are likely to be effective and whether there are any concerns with the ones suggested?

1.38 Respondents provided mixed views on the proposals for incentives and disincentives to reduce the risks of key staff leaving the firm without complying with their notice periods. While most responses supported the policy objective to ensure the retention of key staff on insolvency, there were some concerns expressed and questions raised about the design and effectiveness of the proposal. These included reservations around the scope of the measure, and in particular about the 90-day notice period for continuation of key staff and suppliers, which was thought likely to be costly for firms in the event of failure.

1.39 There were some suggestions that insolvency- proof contracts as suggested were impractical as firms cannot force or oblige staff to stay on, especially if payment is not guaranteed. There were also doubts expressed about the clawback of remuneration in the event of staff leaving, as such a move can be open to legal challenge and may contravene human rights laws.

28. Are there any other areas and activities for which key staff should be retained? Do you agree with the Government's proposed approach for the firms to identify key staff to be retained?

1.40 Respondents made specific points around the definition of key staff. Some respondents felt that insolvency- proof contracts should apply to all staff, while others felt strongly that just key staff such as those working on IT systems should be included. Some respondents questioned whether such provisions should not also be made applicable to other types of firms.

1.41 In general, respondents agreed with the key business areas outlined, although some felt that the approach of identifying key staff should remain flexible so that firms can identify key roles themselves.

29. What do you consider would be an appropriate measure to ensure that the fees that vendors charge post insolvency are not inordinately high? Do you believe the Government can take specific action in this regard?

1.42 Most respondents felt this was a commercial issue, and that the Government should not intervene. However, some respondents suggested extending a creditor moratorium or section 233 of the Insolvency Act to ameliorate any problem of insolvent firms being "held to ransom" by suppliers.

30. Costs associated with this policy would depend on exact conditions of contracts and the number of key staff or nature of services required. The Government recognises that cross-border groups with investment banking business may negotiate contracts with staff and service providers on a central, group-wide basis. The policy proposed here is likely to lead to additional costs for negotiating contracts specific to individual legal entities.

Stakeholders consider the legal costs of re-negotiating contracts for both staff and suppliers to be in the region of £40,000 to £200,000. Although it is possible that these costs are high, the Government understands that they are unlikely to be as substantial as costs of on-shoring systems and services.

Do you agree with the estimate of costs of contractual provisions for key staff and suppliers? What are your views on the incremental costs of: (i) re-negotiating contracts with vendors; (ii) putting in place appropriate contracts with key staff and (iii) creating an on-shore IT infrastructure to the extent that it is essential for wind-down in an insolvency?

1.43 On staff contracts, some respondents pointed out that if existing contracts have to be renegotiated, then the cost impact may be unacceptably high. However, no respondents provided any alternative costs, on the basis that these will vary widely depending on scope, size and type of business.

1.44 On costs generally, respondents suggested that actual costs would vary widely depending on the size and complexity of the firm, and on features of the suppliers, such as location and status. While respondents did not provide alternative costs, there was, however, concern expressed about the potential costs outweighing the potential benefits where smaller or less complex firms were concerned and that the costs might put UK firms generally at a competitive disadvantage.

31. What alternative policy tools if any could be considered to ensure continuity of essential services and key staff post insolvency? Are there any likely impacts on the competitive position of UK firms from this proposal?

1.45 Some respondents agreed that the proposed insolvency-related contractual provisions for the firm's staff and suppliers would help in insolvency, but had reservations about the extent to which making these contracts 'insolvency-proof' would be possible.

32. What are your views on legislative changes requiring administrators to use the operational reserve only for operational expenses?

1.46 Respondents were divided on whether this legislative requirement should be introduced. Some were of the view that the administrators would, in discharging their duties, already have to have regard to the resources available to them to meet their objectives and that, in most cases, this would involve the reserve being used for operational expenses as the administrators pursue the special administration objectives. However, others felt that this might not provide suppliers and staff with the necessary confidence for the payment for their services.

33. Initial discussions with stakeholders indicate that an operational reserve of $25-50 million would be required for the investment firm's prime brokerage business and the annual opportunity cost of such funds is likely to be about 30 to 40 basis points.

In addition, the firm may need to include funds within the operational reserve for incentivising key staff to continue post insolvency. This is likely to amount to approximately $10-30 million for key staff only of the entire investment banking business of a firm. As above, the annual opportunity cost of such funds is likely to be about 30 to 40 basis points.

Do you agree with these cost estimates? What is your estimate of the value of the operational reserve for the entire investment banking business of the firm, including monetary incentives for key staff, if any?

1.47 Respondents commented that the operational reserve requirement could increase the costs of doing business and create a category of preferred creditors. The monetary incentive for key staff was also viewed as a potential reward for failure.

34. Do you have any concerns about the operational reserve proposed in Chapter 3?

1.48 There were a number of responses which opposed the reserve, on the basis that it overlaps with existing FSA capital requirements.

Responses to chapter 4: reconciling and returning client property

1.49 The questions in this section relate to proposals aimed at improving outcomes for the clients of a failed investment firm. Clients may be particularly affected, since their assets and money, to which they have a proprietary claim, can become trapped in the failed estate. It is important for the proper functioning of the market that such assets can be released to their beneficial owners as quickly as possible. These proposals are also intended to improve the protections for investment firm clients at a pre-insolvency stage.

1.50 The FSA has already consulted on a number of the regulatory proposals set out in chapter 4 of the December consultation paper, in FSA CP 10/9, *Enhancing the client assets sourcebook*, published in March 2010.

35. Should the Government look to provide clarity over how shortfalls in client asset omnibus accounts are treated on insolvency? Should the Government look to provide clarity over when clients' entitlement to their assets should be calculated?

1.51 Respondents were generally in favour of increased clarity over how shortfalls would be allocated. That said, some respondents believed this is something which would be better addressed through regulation or the forthcoming European Securities Directive.

1.52 Comments also referred to the need for greater awareness amongst investors through investor education. References were also made to ongoing court cases involving Lehman Brothers International Europe, and to the views of the Financial Markets Law Committee and its paper *Property interests in investment securities*, published in 2004.

36. Do you agree with the Government's proposal of mandating warnings over the implications of allowing rehypothecation and omnibus accounts in relevant agreements? Should firms be required to offer clients designated named accounts at custodians?

1.53 Respondents took different views on the proposal for mandated product warnings. Although the majority supported increased clarity, there were different views on whether mandated product warnings would be effective, with most respondents preferring market action in this area to increase industry awareness.

1.54 In terms of requiring firms to offer designated accounts, some respondents opposed this requirement on the basis that it would be impractical to manage designated accounts and would add significant costs to the firm, while others believed that offering designated accounts alongside omnibus accounts would give clients the choice to pay for an additional segregation of their assets.

1.55 The FSA has now consulted, in CP 10/9 on measures to increase clarity in contractual arrangements through additional disclosures in the annex of prime brokerage agreements.

37. Do you agree with the Government's aim to encourage clarity in contractual agreements? If so, how is this best achieved?

1.56 Respondents in general welcomed the Government's aims in this area. It was broadly felt that a market response would be the most beneficial and that legislation or regulation is not required.

38. Initial discussions with stakeholders indicate that there would be a one-off cost of £9,000 per warning in legal costs (calculated at 30 legal hours at £300 an hour) for firms to integrate additional text around each of the following areas in standard contractual agreements:

- warnings on rehypothecation; and
- warnings on omnibus accounts.

Do you agree with the costs suggested above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

1.57 In general, respondents thought that the costs set out in the question were somewhat underestimated, given the likely costs to firms when warnings are added to documentation. For example, legal reviews of existing material and further assessments might be required under the measure. One respondent quoted a figure for one-off costs of £20,000.

1.58 The FSA has now done its own cost benefit analysis in CP 10/9 for its proposal in this area.

39. Do you agree with the Government's proposal of increased reporting requirements for systemic investment firms? If so, are there any issues around the timing or content of reporting that the Government should consider?

1.59 While there was general support for increased transparency on the basis that this is critical to the UK's attractiveness as a financial centre, some respondents were more mindful of the proposed scope of the increased reporting proposal and the potential for increased costs. Others felt that any increased reporting requirements should apply to all firms holding client money and assets, not just systemic investment firms.

1.60 The FSA has now consulted on increasing and standardising reporting requirements for prime brokers in CP 10/9.

40. Do you agree with the Government's proposals for increased record keeping requirements for investment firms? Should the Government require settlement date record keeping, as well as trade date record keeping on custody systems?

1.61 The majority of respondents felt that the current record keeping requirements were adequate in terms of the existing CASS regime. Any additional efforts should therefore be focused on adherence to those rules.

41. Do you agree with the Government's support for increased audited disclosures by firms around client money and assets? Should firms be made to make available audited client money and assets reports to clients?

1.62 Respondents were generally against making audited client assets reports available to clients, as it was felt that it is unclear what the clients would do with the reports or what benefit they would serve. However, some respondents believed this proposal could increase transparency.

1.63 CP 10/9 sets out FSA's intention to publish a further consultation paper in September 2010 that will consider refining the scope, and increasing the standard, of audit reporting.

42. Should the Authorities clarify the scope of FSA CF 29 and centralise CASS oversight under one individual?

1.64 Respondents broadly supported this proposal but felt that the individual would need to be someone from senior management, with sufficient authority across the firm to have oversight responsibility for client assets and money.

1.65 The FSA published its intention to consult upon a client assets controlled function in CP10/3 '*Effective Corporate Governance* published in (January 2010, and further consulted upon creating a client assets oversight controlled function in CP 10/9. This would require one person at each firm to have ultimate oversight responsibility for client assets and money, even though the firm may structure its business so several people across numerous departments have relevant roles.

43. Our initial discussions with stakeholders indicate that:

- there could be a one off cost of $1.5m for a firm to build a reporting system, assuming that they did not have such a system already in place. If it did have a reporting system in place, it could cost an estimated $0.5m to expand its capabilities. Ongoing maintenance of a reporting system could cost up to $2m. Record keeping costs could be subsumed within the costs of the reporting system;
- requiring firms to increase their audited disclosures could lead to ongoing annual costs of £30,000, based on 200 additional auditing hours at £150 per hour; and
- there would be a negligible cost of clarifying the scope of controlled function 29.

Do you agree with the above costs, if not, please provide an estimate of costs that are likely to occur, stating your assumptions?

1.66 Those who responded to this question were unable to provide clear views on costs, owing to the many potential variables in place or unknown levels of work required to build new reporting systems. Most agreed that the impact of costs across firms could impact disproportionately on smaller firms. The FSA has now published its own cost benefit analysis in CP 10/09 for its proposals in this area.

44. Should the Government support the establishment of bankruptcy-remote vehicles for client assets through regulatory or legislative measures? If so, how could Government provide effective support?

1.67 Respondents were broadly in favour of this market-led proposal, and were generally of the view that Government intervention was unnecessary.

45. Do you agree with the Government's proposal of limiting the transfer of client money to affiliates, and jurisdictions where there are potentially interoperability issues with CASS?

1.68 There were mixed views from respondents on this proposal, with some believing a cap on the amount of client money that can be held with affiliates would be beneficial in reducing the risks of intra-group contagion, while others thought this was more an issue around disclosure.

1.69 The FSA has now consulted on a 20% cap on the amount of client money that can be held with affiliates in CP 10/9.

46. Should firms that manage client assets be required to obtain letters from custodians stating that there are no set off and liens over client assets in respect of liabilities owed in a principal capacity by the firm?

1.70 Many respondents pointed out that custodians operating in overseas jurisdictions may not cooperate with such restrictions. There were also concerns that such a proposal may mean that investment firms stop holding their own assets at the same custodians as their clients to avoid their assets being under charge instead.

1.71 The FSA has now consulted on this proposal in CP 10/9. It is proposing to create a rule to prohibit firms using general liens over client assets which are held under custodian agreements, except to cover the situation when a firm (or if the client has a direct relationship with the custodian, the client) does not pay custodian fees and charges to the third party holding the custody assets.

47. Should firms be required to have the capacity to separately pool client money relating to riskier activities?

1.72 Respondents to this proposal were generally opposed, on the basis that it would complicate the client money regime, and could give the impression that some client money is not as protected as other client money.

48. Do you agree with the Government's proposals for establishing bar dates for client claims? How should clients' rights to their money and assets be affected by a failure to summit a claim by a bar date? Should the Government impose a legal duty on an administrator or trustee to impose a bar date?

1.73 Although there was general support for the bar date proposal from respondents, there were differences of opinion on whether a bar date should extinguish a client's proprietary right to their trust assets, thereby converting the client to an unsecured creditor if they fail to submit a claim. Some felt that a compromise may be to set a date for submission of notification of trust rights on the basis that notifications received by the relevant date would be dealt with first, and that later notifications would not lose their trust rights but would still be entitled to redelivery of their assets to the extent available, and otherwise would have tracing rights in the usual way.

49. Our initial discussions with stakeholders indicate that:

- requiring investment firms to limit the transfer of client money to affiliates could cost around £15,000 (50 legal hours at £300 per hour) in legal costs.
- there could be a one-off cost to firms of £15,000 (50 legal hours at £300 per hour) in legal costs per custodian to renegotiate their agreements. Additionally there could be additional charges: for example, custodians may charge a fee (a basis point charge calculated on activity) or they may require average turnover pledged on an account.
- there could be a one-off cost to firms of £15,000 – £1m depending on the extent to which firms already have the capability of dividing client money into different pools. There could also be an annual maintenance cost to firms of around £750,000 to maintain these separate pools.
- there would be negligible costs to clients of requiring them to submit their claims by a bar date.

Do you agree with the costs suggested above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

1.74 Those who responded believed that the estimated costs were hard to confirm as they would depend on the size and complexity of the firm. They also pointed out that legal fees that may be incurred from some of the proposals could be in excess of the hourly rates set out in the

consultation. The FSA has now conducted its own cost benefit analysis in CP 10/09 for its proposal to cap the amount of client money that an investment firm can hold with its affiliates.

> 50. Would the Government's proposals in the area of client money and assets allow sufficient flexibility to enable investors and investment firms to meet mutually acceptable outcomes? Are the proposals 'future proof' and do they have a limited negative impact?

1.75 A clear majority of respondents felt that it would be impossible to 'future proof' any proposals on client money and assets. The innovative nature of financial markets means that it is highly likely that a new product, or range of products, will be developed which fall outside the scope of these proposals. However, if they were kept under review, they would be able to be modified as required to keep up with financial innovation.

> 51. Do you have any other views on the issue of client money and assets that you feel are important for the Government to consider?

1.76 Some respondents felt that the problems experienced in returning client money and assets to clients with the insolvency of Lehman Brothers, and other investment firms, are due to a lack of adherence by the firms to the FSA's CASS rules, as opposed to any fundamental flaw with the rules themselves.

1.77 The Government notes that the FSA has significantly increased its resources focused on client assets and money supervision and believes this is an important step to ensure strict adherence by firms to all CASS rules.

Responses to chapter 5: providing clear and effective support for clients

1.78 The questions in this chapter relate to the creation of a client assets agency (CAA) for pre-insolvency supervision of client money and assets and the creation of a client assets trustee (CAT) to handle the identification and distribution of client money and assets post insolvency. The CAA and CAT proposals were set out as additional options that would complement the regulatory and legislative proposals set out in chapter 4 of the December consultation paper.

> 52. Do you agree with the duties and proposed scope of the CAT? Should the scope be widened to include all investment firms? Should the Insolvency Practitioner be appointed from the same insolvency practice as the administrator or from an independent firm?

1.79 Respondents were generally against the CAT proposal for the following reasons:

- experience in relation to LBIE showed that it is often necessary to deal with unsecured claims and trust assets together in order to determine a beneficiary's net claim to the trust assets;
- it may take months (if not years) to work out whether the money or assets in question is trust money or assets or whether such money or assets were provided on title transfer terms;
- there could never be a clear delineation of roles (except perhaps in the case of a pure custodian), and therefore there would be a degree of duplication between the tasks performed by the administrators and the CAT; and

- there would be an increase in the costs of the insolvency process overall.

1.80 Respondents indicated that they strongly favoured the alternative proposal that administrators should have as one of their special administration objectives the duty to ensure the prompt return of client assets and monies. This amendment to an administrator's duties, combined with the bar dates proposal, and other measures which were set out in the December consultation paper, were considered the best way to improve outcomes for clients.

53. Do you agree with the Government's suggestions for how the CAT could be established? What do you see as the advantages and disadvantages of the two suggested legal methods of establishing a CAT?

1.81 As indicated above, respondents were generally opposed to the creation of the office of CAT.

54. Should the costs of the CAT be funded from the client money and assets of the firm, or from the insolvent estate?

1.82 Respondents generally felt that that if a CAT was to be established, then in the interests of fairness, it should be those who stand to benefit from the measure who should pay for it. In particular, the CAT should be funded from the clients' money and assets rather than from the insolvent estate.

55. Do you agree with the proposal to establish a CAT? Should the Government favour alternative measures for improving client outcomes, such as the proposal in Chapter 2 to amend the legal duties of administrators to require them to prioritise the return of client money and assets?

1.83 As indicated above, respondents were generally opposed to the creation of the office of CAT.

56. It is expected that any additional costs of the CAT proposal would be negligible due to the assumed faster return of client money and assets by the CAT, and the resulting fall in expected administration costs. Do you agree? If not, please provide an estimate of any costs that are likely to occur, stating your assumptions.

1.84 Respondents disagreed with the assertion that costs of the CAT would be negligible, arguing instead that it would lead to additional costs, and would not necessarily result in a faster return of client money and assets. Some respondents estimated that that the overall costs of dealing with insolvent estate and third party assets would be likely to rise by a substantial amount, potentially up to 50-100%.

57. Do you agree with the proposal that an individual from the CAA should be able to perform the CAT role, where this is desired by the regulator?

1.85 Respondents were again generally unsupportive of this suggestion. Few thought that, in the event of the formation of a CAT, it would be appropriate for anyone from the CAA to take on this role. This is because it is unlikely someone in this position or circumstance would have the means to effectively perform this role compared to a licensed Insolvency Practitioner, who is

more likely to be familiar with the issues, as well as being subject to the usual information requirements and liabilities and accountable to the courts.

58. Do you agree with the Government's proposal to set up a CAA? Do you agree that this should be established as a distinct body within the Financial Services Authority?

1.86 Those responding to this question were generally against the creation of a CAA, largely on the basis that they were unconvinced of the merits of such a proposal, or thought that the CAA would be unnecessary given the existing scope for the FSA to take action in this area.

59. Should the FSA be granted powers to sit on the creditor and/or client assets committee by right, to enable it to monitor and, if required, challenge the administrator or CAT? Should such a power include the right to vote?

1.87 Respondent were, again, generally against this suggestion. While some could envisage a situation where the FSA sat on client committees as a regulator, it was unclear to respondents what the benefits of this would be, or what could be achieved since the procedures relating to the creditors' interests are prescribed by law. For example, there was some scepticism about what the regulator could review, challenge and/or seek to revise.

60. Should all firms currently regulated by the FSA and holding client money and assets, as defined by the FSA's CASS rules, fall within the jurisdiction of the CAA?

1.88 Although respondents were generally uncertain of the merits of the proposal for the establishment of a CAA, most respondents to this question were of the view that if the CAA was to be introduced, then the regime should apply to all regulated firms that deal with client money and assets as this will ensure a level playing field, to ensure that investors received the same level of regulatory protections regardless of size or systemic importance.

61. It is expected that the FSA will allocate more resources to client asset risks in the future, to perform work that could be taken on by the CAA. The incremental costs of the CAA are therefore expected to reduce. Do you have any comment on this?

1.89 Responses to this question revealed no consistent shared views on the issue, although most respondents reiterated their opposition to the CAA, with some highlighting the potential for extra costs to be generated by the set-up and management of the CAA.

62. Do you have any other views on the establishment of a CAT or CAA that the Government should consider?

1.90 As already summarised extensively, on the whole, respondents felt that the establishment of a CAT and CAA would be unnecessary and supervision of firms' adherence to client money should already be catered for under the existing supervision conducted by the FSA. They also felt that the separation into two agencies of client assets will cause confusion, increase delays, increase costs and would prove to be impractical.

Responses to chapter 6: reconciling counterparty positions

1.91 The questions in this chapter relate to proposals to mitigate the impact of investment firm failure on the market counterparties of the firm. The proposals are designed to improve the functioning of market infrastructure in the event of an investment banking failure.

Trade system of origin flagging

63. Throughout this document, the Government is seeking stakeholder input to assess the likely costs of proposals. Preliminary work with the industry indicates that regulatory action, should it be needed, would have a negligible cost for firms, as it would simply be a matter of reiterating to staff the meaning of different flags and when they should be used.

Do you agree with this assumption? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

1.92 Respondents generally agreed that costs would be negligible.

64. What action should market participants take to address these issues? Do you believe regulatory action to address the issue of TSO flagging is needed?

1.93 Respondents agreed that incorrect "trade system of origin" (TSO) flagging is a significant issue. One respondent insisted that regulatory action is not required at this stage as market action is underway to resolve the issue. The majority of respondents, however, argued that a regulatory response is necessary. It was suggested that the FSA should put in place systems to evaluate data and highlight the trading venue of trades reported to it as part of the transaction reporting process, introduced by MiFID. Other respondents argued that the most effective role for the regulator is to provide guidance and training, as it would be impractical and highly costly for TSO flagging to be directly supervised or inspected.

1.94 One solution suggested was that clients be permitted to make the selection as to whether their trades should be booked formally to an exchange or clearing house, if it has been executed outside an exchange or clearing house, to provide access to default protection (part 7 of the Companies Act 1989) for all the client-facing trades. The issue was also raised of major UK broker-dealers using terms which allow them to transfer trades around, and potentially out of, the group, often based outside the UK. These contractual terms would effectively override protections the UK might seek to introduce for UK investors.

Default arrangements for MTF trades

65. What would be the advantages and disadvantages of extending Part 7 type protection to cover the default rules and trades of Multilateral Trading Facilities (MTFs) for all affected parties, including creditors? What other options should the Government consider?

1.95 The responses broadly supported the extension of Part 7-type protection to MTFs in order to deliver enhanced transparency and certainty of outcome. There were differing views among respondents around some of the details, however. A question was raised about the scope of MTFs that should be covered by Part 7-type protection. Some respondents argued that protection should be universally applied, others that all MTFs should be allowed on a voluntary basis to opt-in. A third suggestion was that the FSA apply a threshold test to determine an MTFs entitlement to opt-in.

1.96 Further questions were raised around the mandating of default rules. It was argued that if default rules remain optional then substantial uncertainty may remain in the market, in spite of Part 7-type protections. However, there was a question as to whether rules should be standardised: it was argued by some respondents that a proliferation of different default rules for different trading platforms in the same market should be avoided; however, it was also argued that default rules should not be mandatory for all MTFs given their different business models. It was suggested that minimum standards or requirements are put in place to ensure that rules are sufficiently comprehensive.

Default arrangements for OTC trades

66. Do you agree that the AFME Protocol is a sufficient solution for the issues identified around OTC cash equity trades not covered by default rules or default terms of business? How could the Protocol be improved?

1.97 There was a split in views from respondents, depending on whether they represented the views of buy-side or sell-side firms. The sell-side argued that the protocol is a sufficient solution to the issues around OTC cash equity trades not covered by default rules or default terms of business, provided that its flexibility and adaptability does not come into conflict with the obligations and duties undertaken by parties involved with an administration. The buy-side contended, however, that the protocol is insufficient on the grounds that it is designed for principal to principal business, and does not address the needs of investors who are agents for underlying clients, such as discretionary investment managers. Buy-side respondents expressed preference for a further solution, potentially by extending the protocol so that it works for agents as well as principals conducting an OTC market trade. They noted also that the protocol can only operate effectively if the TSO issue is resolved.

67. Do you believe the AFME Protocol, or an equivalent, should be placed on a regulatory footing? What would be the advantages and disadvantages of this step?

1.98 Sell-side respondents argued against putting the protocol on a regulatory footing, as the use of this contract is a commercial rather than regulatory matter. There was further scepticism about the merits of placing the protocol on a regulatory footing given the potential conflicts with existing legislation. Further, the flexibility and adaptability of the protocol would be compromised were changes in regulation, requiring due process, needed to affect any amendment.

1.99 The buy-side argued against placing the protocol on a regulatory footing at this stage because it fails to address the issues affecting agents with underlying clients. Hence, a regulatory endorsement at this stage would give a misguided signal that a satisfactory solution had been reached. The buy-side's priority therefore appears to be to see the protocol, or similar agreement, extended to cover agents.

1.100 The sell-side was not opposed to extending the protocol in this way, rather they believe focus in the near term should first be on obtaining agreement from the major sell side participants, and on implementation of the protocol by a critical mass of investment banks.

68. Do you have views on the valuation mechanism which should be used in a market Protocol on OTC cash equity trades? In particular, should it be gross or net, and what would be the advantages and disadvantages of each methodology?

1.101 Sell-side respondents supported the consistent industry-wide use of a net valuation mechanism as it has been tried and tested in other markets. However, other respondents argued against netting. Calculating gross positions puts the onus on counterparties to make claims against the estate, rather than the estate having to pursue counterparties who might delay valuations indefinitely if they stand to make a loss on a transaction, or value open contracts at unrealistic prices to serve their own interests. Further, as asset managers trade as agents on behalf of separate and independent funds, set-off between such funds is not possible.

69. Are there any other asset classes that the Government should consider for which lack of default terms has proved problematic in the event of the insolvency of a counterparty, or may in the future? If so, please specify.

1.102 Respondents were supportive of expanding the protocol to further asset classes. It was argued that there is no reason why default terms should not apply across all cash securities markets, if they are to be applied to equity markets. Buy side respondents suggested Forward FX in particular as an asset class to be included. Some sell side respondents are supportive of expanding to other asset classes, though were conscious of the issue of how default terms are in practice exercised in the trading and settlement process. They were confident that a market- led solution will be developed.

Clearing: portability of margin and positions

70. What would be the advantages and disadvantages of extending the protections provided by Part 7 of the Companies Act 1989 to cover underlying client trades for clients, counterparties and creditors? Can you give any indication of the possible costs and benefits of intervention in this area, and its distributional impact?

1.103 In Respondents saw benefits in the certainty associated with the override of insolvency law in relation to underlying trades as this is conducive to the smooth porting of trades and margin, which effectively ensures that the market remains operative notwithstanding a large default. Respondents also suggested, however, that these protections should be considered alongside other reforms, such as those affecting client money. Some respondents pointed out that protection may already otherwise be available and, as such, opposed the proposal.

71. Are there any other solutions the Government should be considering to promote margin portability?

1.104 There were no substantial recommendations for alternative solutions. However, several respondents suggested particular issues for further consideration, including:

- whether gross margining would not be cost effective in the highly liquid futures and options markets;
- whether the Government, in light of its objectives, should consider the arguments for and against interoperability between clearing houses in relation to clients, rather than focusing on broker-dealers;
- whether consideration should be given to the interaction between a clearing house's default rules and applicable client asset protection regimes; and

- whether the Government might explore the transfer of trades between the clearing members of different exchanges, where contract offsets and related services already exist.

Clearing: segregation of investment firm and client accounts

72. Early discussions with stakeholders indicate that there would be negligible costs for market infrastructure providers and market participants in mandating the offer by CCPs of segregated accounts, as this is already offered as standard by CCPs in the UK. The Government would welcome comments on this assumption.

Initial discussions indicate that mandating investment firms to offer a choice of account at clearing would have an average one-off cost, per investment firm, in the region of US $5-10 million for an investment firm to develop this capacity, and an approximate annual maintenance cost of $5 million. The Government would welcome feedback to improve this estimate and, in particular, how it might impact on firms of different sizes.

Do you agree with these costs? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

1.105 In respect of the cost benefit analysis, respondents suggested that the Government should also take into account post-implementation costs and the variability of costs between market segments and firms. They further noted that annual maintenance costs would ultimately be charged back in full to the client base.

73. Do you agree there would be value in the introduction of an explicit requirement that CCPs offer facilities for members to segregate their business?

1.106 The response to this question was mixed. Those that supported an explicit requirement thought it would provide added assurance and confidence for clients and help avoid a situation similar to that following Lehman's collapse. However, the markets will have to weigh up the balance between higher costs and the provision for more assurance for clients.

1.107 Those against argued that CCP's current practice already offers segregated accounts, and as such there is no need for Government intervention. Responses from legal stakeholders argued that to promote segregated clearing, the correct regulatory lever should be a requirement at the level of the investment firm, not the CCP. They further noted that for non-UK CCPs, segregation may be problematic in light of market norms and/or the domestic legal structure.

74. To what extent is it necessary to require clearing member investment firms to offer their clients a choice of account types for the purposes of clearing? What would be the advantages and disadvantages?

1.108 There was a belief expressed among some respondents that the market will deliver an effective solution and that Government intervention would add an unnecessary extra cost. Legal respondents were clear that a market failure does exist but contended that the market is adjusting to this failure and so regulatory tools are not needed to mandate segregated offerings.

1.109 Others argued that investment firms should not be allowed the option of offering only one type of service. Choices should be limited, however, to the extent that reasonable investor expectations as to outcomes are first met.

75. Are there any other issues which you believe need to be resolved at clearing level, regarding the insolvency of an investment firm? If so, please provide details.

1.110 Two broad recommendations were suggested. Firstly, greater focus on the position of CCPs within the international system, in particular the interconnectivity (and therefore contagion risk) of cross-border lending. As such, stakeholders welcomed cross-border initiatives to coordinate default arrangement. Secondly, respondents believed it would be helpful for CCPs to provide more information about their own structure, rather than investment firms providing this information to their clients on their behalf.

Settlement: the CREST system default arrangements

76. Does EUI's proposed approach to settlement provide greater predictability and are there ways it could be improved?

1.111 Responses to EUI's proposal were mixed. The supporters of the proposal said that this approach appears to be the most effective way to mitigate the uncertainty associated with unsettled instructions in the CREST system in the event of default of a participant. However, they pointed out some issues which need to be considered in implementing this proposal; for example, the necessity to harmonise with any relevant EU policies to ensure there are no direct or indirect conflicts and to maintain the competitive position of the UK financial services industry. It was also recommended that more consideration be given to the necessary legislative changes; i.e. the Uncertificated Securities Regulations 2001. A further observation was that the proposal, by freezing the insolvent entity out of CREST, would prevent its clients from making choices about which trades with particular counterparties it wished to settle.

1.112 The respondents who took greatest objection to the proposal did so on the grounds that all transactions should settle at the moment of insolvency, rather than be frozen and then removed at a later date. It was queried why EUI did not follow its own rules in relation to pending settlements involving Lehman's insolvency, allowing trades to settle given that the transactions could no longer be deleted from the system by one party unilaterally.

77. Have the key consequences been identified correctly and do the benefits for the market as a whole of the proposed revised approach outweigh these consequences?

1.113 Respondents from both the buy- and the sell-side believed that costs and benefits had been adequately accounted for and that benefits for the market as a whole would outweigh the costs and any potentially adverse consequences. However, it was noted that an insolvent entity may struggle to fulfil its trading obligations because of the time required to re-input trades into CREST if it wished to settle existing trades, leading to potential disputes with clients and counterparties with potentially greater losses suffered as a result. It was also recommended that a change be made to the Settlement Finality Regulations to clarify the term "collateral security" for the benefit of commercial counterparties wishing to make use of securities held in EUI as collateral.

Contractual terms between investment managers and investment firms

78. Do you believe that Government action is required to address contractual terms issues?

79. If you do believe regulation or legislation to address terms of business between investment firms and investment managers is required, which issues do you think are the highest priority? Which types of measures would best address them?

1.114 Respondents on the sell-side, as well as legal and accounting firms, contended that Government action is not required to address contractual terms. It was argued that intervention would only be justified if it were an appropriate response to a clear case of market failure. The belief is that no market failure exists and that disputes are typically questions of allocation of legal and commercial risk. Were these disputes to have systemic consequences then an argument could be made for legislative or regulatory intervention, however it is not believed that this is the case.

1.115 Buy-side respondents argued that Government action is necessary given the scope of terms that have become negotiable and the long standing inability of the market to deliver a solution. Respondents were unclear as to why the sell-side cannot agree terms that, they argue, reflect the genuine requirements of clients. A question was raised as to whether this rigidity reflects a lack of competition.

1.116 Some respondents took a more middle-ground position, agreeing that this is a matter of concern that the Government should wish to see resolved, but that this may be done so through a market convention or code, even for these most basic terms.

Responses to chapter 7: managing complex creditor positions

1.117 The questions in this chapter relate to proposals to mitigate the impact of investment firm failure on the creditors of the firm.

OTC derivatives

80. Do you agree that regulatory or legislative action is not required if a suitable market solution is reached with respect to the issue of terminating derivatives contracts as set out above? Do you have views on what type of regulatory or legislative action will be most appropriate should there be no market solution to this issue?

1.118 There was broad support from almost all respondents that regulatory or legislative action would not be required if an appropriate market solution was reached to solve the issue of terminating derivatives contracts. Many respondents suggested, in addition, that it is crucial to ensure the freedom of contract and allow a reasonable period time for a non-defaulting counterparty to close its open positions.

1.119 There was a mix of opinions as to the appropriate response should the market to fail to reach a satisfactory solution. Some respondents held the view that Government intervention would not be feasible, much less necessary or desirable. Other respondents referred to the possibility of regulatory or legislative action, on the grounds that the refusal by non-defaulting counterparties to terminate contracts is a source of major uncertainty.

Managing trading book risk

81. Do you agree with the proposal for a resource centre to aid administrators of investment firms?

1.120 Almost all respondents disagreed with this proposal. The main reasons given for this opposition were the costs associated with establishing and maintaining the resource centre, and the availability of appropriately qualified risk managers whose expertise can be kept up-to-date. There was also a view that the administrator's expertise would be sufficient to meet the challenges of an investment banking resolution and a resource centre would merely duplicate the already existing expertise. Furthermore, the resource centre would not address the difficulties of reconciling OTC derivatives close-out valuations that have arisen due to the subjectivity of valuation and not due to a lack of resource.

Repo-market close-outs

82. Do you have views on the difficulties that repo market transactions could pose for the insolvency of an investment firm, affecting value recovered for creditors? If this is a concern, what kind of policy action could the Government consider to address it?

1.121 All respondents believed this issue should be resolved through market-led solutions not through legislative or regulatory action by Authorities as this can impact on the freedom of contract. It was noted that the evolution of market terms is a natural function of changed market conditions. Over-collateralisation and associated insolvency risk in the repo markets is a commercial risk that should be mitigated by improving risk management in firms and their clients. Some respondents emphasised that it would only be once the whole portfolio had been sold off that a determination could be made as to whether or not there was any over-collateralisation.

Mitigating negative externalities

83. In relation to these areas, are there any concerns that would substantially change the distribution of the outcome? Are there any other areas not covered here, that may create negative externalities for unsecured creditors?

1.122 No responses identified any additional issues that might create negative externalities for unsecured creditors.

84. Are there any specific factors with respect to the loss of market confidence and complexity of business that affect unsecured creditors, which are not addressed and which the Government should consider?

1.123 Respondents urged the Government to consider the impact of "too much" regulation on the attractiveness of the UK as a place to do business and the consequent shifting of operations outside the UK that could result.

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