Establishing resolution arrangements for investment banks

The ABI's Response to HM Treasury's consultation paper

Introduction

1. The ABI is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters.

General comments

2. Our Association welcomes the initiative of HM Treasury in taking forward the UK authorities' thinking on this important subject, and the opportunity to respond to the consultation paper. The Investment Management Association has responded at greater length on many of the detailed aspects raised in the consultation and, in so doing, they have represented the generic views of the investment management community. The Association of British Insurers wishes, in registering our broad support for this work, wishes to emphasise key messages.

3. The consultation paper's focus, as conveyed in its title, is on resolution arrangements for investment banks, and rightly so. However no clear definition of such institutions is provided and it is evident that the impact of the proposals could extend more widely. We understand that HM Treasury is seeking to ensure that the scope of these arrangements relates to activities as opposed to status of different institutions. This is a sensible aim though we are concerned at the possibility of too wide a range of institutions being drawn into the net.

4. We are clear that the activities that that should be targeted are "sell side" in nature, performed by investment banks, prime brokers and the like. It would be wrong to seek to cover investment firms in general by virtue of the fact that they are covered by client money and asset rules. In addition, however, we are mindful of the considerable ancillary importance of custodians within the market infrastructure relevant to the matters being consulted on and we consider that they should be within the scope of the any arrangements to the extent that this is appropriate.

5. By contrast, neither insurance companies nor asset managers pose the type of risks that require the existence of special remedies of the type envisaged in the consultation paper. Insurance companies have liabilities that crystallise often only over the very long term and the winding down of such institutions may take place over a much longer time span than would be appropriate for other sectors of the corporate economy. This is in marked contrast to the banking sector where speed

and flexibility will be critical. Insurance companies may be of great importance but they are not associated with systemic risk in the way that banks are.

6. Unlike banks and insurance companies, asset management companies manage but do not hold client assets and money, these being instead held by custodians, banks or a depositary. Client title will therefore be unaffected by the insolvency of the manager. We do not believe there are any special features of asset management business that call for additional tailored administration or resolution arrangements in insolvency under the investment banking related proposals being considered in the consultation paper or otherwise.

7. The main interest that our Members have in this consultation is that as “buy side” institutions they are themselves the clients of investment banks and other “sell-side” institutions the insolvency of which have been demonstrated during the banking crisis to have been the cause of major systemic problems to the financial market system. Accordingly, we agree broadly with the aim of the proposals as they address a genuine requirement to reduce damage done to innocent clients when financial institutions of the investment banking type face insolvency.

8. In so far as it is likely that the proposed arrangements will be invoked at a rather later stage than is contemplated under the Special Resolution Regime for commercial banks under the Banking Act there are fewer concerns over rights of shareholders being compromised. Nevertheless we would stress the importance of good governance of these institutions being promoted, this being less likely if the rights of shareholders, including their rights to assent to transactions, are overridden at an early stage.

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ANNEX

Questions for Consultation

Chapter 1

Q1 Do you have any comments on the proposed definitions of investment firm for the purposes of this work?

We suggest that serious consideration be given to specifically exclude certain types of institution from the definition. If that approach is taken forward insurance companies and asset management companies should be excluded from the definition.

Chapter 2 Enabling an orderly resolution

We have no specific comments on the questions raised in this chapter.

Chapter 3 Requiring firms to mange for failure

Subject to 'investment firm' being sufficiently tightly defined we think that the proposals in this chapter for requiring Business Resolution Officers and establishing their responsibilities are sensible and proportionate.

Chapter 4 Reconciling and returning client property

The proposals in this chapter are of key importance in safeguarding the interests of clients of sell side investment banking firms. We are broadly supportive of the suggestions made including for:

- Better clarity over how shortfalls in client omnibus accounts are treated on insolvency (Q35),

- Requiring firms to offer clients designated named accounts at custodians (Q36),

- Establishing bankruptcy-remote vehicles for client assets through regulatory or legislative measures (Q44),

- Limiting the transfer of client money to affiliates and jurisdictions where there are potentially interoperability issues with CASS (Q45),

- Requiring firms that manage client assets 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 (Q46).

Clarity in contractual arrangements around netting and set-off (as addressed in Q37) is certainly a desirable aim though it is uncertain how the Government will be able to facilitate this.

We are not fully convinced of the practical merits (as addressed in Q47) of requiring firms to have the capacity to separately pool client money relating to riskier activities and we note that this concept has been proposed previously, in FSA CP38 Protecting Client money on the failure of an authorised firm, but was not taken forward.

Chapter 5 Providing clear and effective support for clients

The proposals in this chapter seem interesting but at this stage are not fully developed and a key question will be whether their benefits will exceed the costs.

Chapter 6 Reconciling counterparty positions

We do not consider (as suggested in Q66) that the AFME protocol should be placed on a regulatory footing. This protocol is an emanation of the market and specifically addresses the requirements of counterparties of principal to principal OTC equity trades. It does not follow, however, that it is appropriate for more general application or suitable for official recognition.

We agree with the suggestion made in Q37 that there should be an explicit requirement on CCPs to offer facilities for members to segregate their business.

The continuing inability of sell and buy sides to achieve agreement on terms of business is a matter of definite concern and is, rightly, also, a matter on which the Government should be keen to see a resolution. It is unclear why sell-side firms are unable to agree terms of business that reflect the genuine requirements of their clients and we would question whether there are competition aspects that lie behind this failure.

Chapter 7 Managing complex creditor positions

We agree (as per Q80) that it would be preferable for a market solution to be reached that creates greater certainty with regard to closing out derivative transactions while preserving the necessary flexibility for the solvent counterparty to decide whether to terminate transactions in an orderly and commercially reasonable way.

It is possible that establishing a client assets agency or client assets trustee could make a material contribution towards ‘mitigating negative externalities’ for creditors. However complexity of creditor positions will still be a pervasive feature of firms involved in investment banking businesses and it will be important that solutions in this area do indeed underpin rather than undermine market confidence in respect of dealing with entities in times of market stress.

Chapter 8 Working towards cross-border resolution

We have no specific comments on the questions raised in this chapter.

19 March 2010

Alex White Esq
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Mr White,

HM Treasury Consultation paper dated 16 December 2010 'Establishing resolution arrangements for investment banks'

We welcome the opportunity on behalf of the Association for Financial Markets in Europe (AFME) to comment on the HM Treasury Consultation Paper on 'Establishing resolution arrangements for investment banks' (the "Consultation Paper").

AFME was formed on November 1st 2009 following the merger of LIBA (the London Investment Banking Association) and the European operation of SIFMA (the Securities Industry and Financial Markets Association). AFME represents a broad array of European and global participants in the wholesale financial markets, and its members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with SIFMA in the US, and the Asian Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association), and provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. For more information please visit the AFME website, www.AFME.eu.[1]

Our full response to the questions is attached in the Annexes to this letter. Annex 1 covers chapters 1 to 3 and Annex 2 covers chapters 4 to 6. With respect to chapter 7, AFME broadly supports ISDA's response to the Consultation Paper, but does not support an administrator resource centre. A summary of our views follows.

General Remarks

In developing the proposals, we urge the UK authorities not to catch peripheral activities inadvertently or take actions without a clear understanding of the likely consequences. This is particularly important because a number of the proposals are inter-dependent and address the policy objectives in different ways. Inter-dependencies are therefore a feature of our response. Further, the definition of 'investment firm' and the question of which firms are of systemic importance therefore need very careful consideration.

[1] AFME gratefully acknowledges the assistance of Ms Claire Pointing of Gide Loyrette Nouel in the preparation of this response.

Special Administration Regime, Resolution Planning and Cross-border Co-operation

We broadly support the proposals for a special administration regime (SAR) and believe that the authorities should have the authority to initiate the SAR across the board to all firms that combine custody and execution services, irrespective of the perceived systemic importance of such institution. We support the need for an expedited insolvency court system and the importance of business continuity as drivers to enable the expeditious closing out of positions and return of client assets. A formal insolvency process should not result in a complete "seizing up" of the failed firm to the detriment of counterparties and the holders of client assets.

In this vein we note that business continuity and the resolution process could be strengthened by recognising that notwithstanding a global firm's multi-layered, multi-jurisdictional holding company structure, it is likely to functionally operate as a single entity. We support the proposals for recovery and resolution planning and a business resolution role, but would suggest that firms have the flexibility to implement these requirements in a way that is appropriate to their structure.

As for a business resolution officer, we support the policy of establishing a role and agree that it could be an effective way for both investment firms and the authorities to ensure that recovery and resolution planning are put in place and kept up to date effectively.

Where insolvencies proceedings run concurrently in multiple jurisdictions, there needs to be greater cooperation, communication and transparency. We look forward to HM Treasury's forthcoming proposals on cross-border insolvency and to working with you on developing them.

Clarity Over Shortfalls

Our response covers the questions of clarity over shortfalls – where we are awaiting the FSA's CASS proposals.

Client Assets Trustee and Client Assets Authority

Most members do not support the creation of a client assets trustee (CAT) at this stage because they believe that the CAT as described would not necessarily speed up the return of client assets and they see a significant risk of additional costly litigation. Some members are attracted to the CAT in principle.

As to the Client Assets Authority (CAA) we are uncertain as to the merits of the proposal for a CAA, believing instead that alternative measures such as enhancement of the existing FSA arrangements around the specialist team responsible for the CASS regime may be more constructive.

Industry initiatives, the AFME Protocol and Extending Part 7 Protection

We support the Government's emphasis on proposals which will enable investors and investment firms to agree improvements to the arrangements covering client money and assets as a matter of contract or as industry-led initiatives rather than via additional regulation.

We also support industry-led moves in a number of other areas, including greater clarity in documentation, and investor education before legislative measures are considered for product warnings, clarity in contractual agreements and of course the AFME protocol in relation to cash equity trades not covered by other default arrangements. We believe there are benefits to extending Part 7 protection to trades entered into on MTFs but we would not want to see a proliferation of default rules.

Finally, we would urge HM Treasury and the Government actively to participate to the fullest extent possible in all relevant EU policy and regulatory initiatives to ensure:

- The Government's proposals in the Consultation Paper do not directly or indirectly conflict with any such proposals; and
- The competitive position of the UK financial services industry is not adversely affected by any such proposals or initiatives.

If you have any questions, please do not hesitate to contact Gilbey Strub (in relation to Annex 1) on 0207 743 9334 and John Serocold (in relation to Annex 2) on 0207 743 9306.

Yours sincerely

JCSerocold

John Serocold

Managing Director

Gilbey Strub

Gilbey Strub

Managing Director

ANNEX 1: Response to Questions raised in the Consultation Paper (Chapters 1 – 3 on special administration regime and resolution planning)

Introduction – Chapter 1

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

In principle, we support the broad MiFID definition of "investment firms" for identifying the firms that are required to establish resolution plans and creating board level accountability for resolution planning. The narrower definition for firms holding client assets as the hallmark of firms subject to the Special Administration Regime ("SAR") also seems sensible. However, there needs to be further clarity on the applicability of the proposals to firms that are both investment firms and deposit takers, ensuring in particular, that there remains a clear distinction between the regime for client assets, in general, and the regime for bank deposits.

The requirement of 'potentially affecting the stability of the UK financial system' could be difficult to define; some firms may pose systemic risk due to their size while others pose risk because of their interconnectedness. As the Government's aim is to protect the reputation of the United Kingdom as a jurisdiction which provides client asset protection with efficient handling of claims in the event of an institution's insolvency, any measures, such as the SAR, that contribute towards this goal should apply across the board to firms which combine custody and execution services, irrespective of the perceived systemic importance of such institution.

We also welcome the recognition that clarity and transparency are critical outcomes of any proposals. To achieve these outcomes in both present and future market conditions, the approach needs to be focused on the function (e.g. the holding of client assets, with a differentiated framework for monies, securities, collateral and custody) of the relevant firm in the context of the desired outcome rather than attempting to regulate firms within a rigid organisational framework.

Enabling an orderly resolution – Chapter 2

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

Before responding specifically to this question, it may be helpful to lay out the components of the SAR:

- the development of Special Administration Objectives **("SAO")** that prioritise the return of client (first) and the continued provision of services to businesses to be disposed of (second);
- the provision of a defence to personal liability for administrators for actions taken in pursuit of the SAOs;
- the provision of a defence to personal liability for directors for actions in accordance with resolution plans; and
- an expedited court process.

Our members broadly support the concept of the SAR and SAOs and the associated policy measures, particularly the importance of business continuity as a driver to enable the settlement of trades in the immediate aftermath of an investment firm failure and secondly to ensure that a formal insolvency process does not result in a complete "shut down" of the failed firm to the detriment of counterparties and the holders of client assets. Continuity is critical to preserving value so that businesses may be sold off or wound down in an orderly fashion.

We welcome the primary objective of the SAOs being the expeditious return of client assets. We also strongly support the Government's recognition that continuity in the provision of services and facilities to businesses transferred in the run up and post-insolvency is a critical requirement to an orderly resolution. In this regard, we observe that it would be helpful if the scope of the moratorium on creditors of a firm in administration could be extended to non-financial contracts to prevent key suppliers from terminating their contracts (provided such suppliers are being paid currently).

For the avoidance of doubt, the carve-out from the creditor moratorium for "financial markets instruments" that currently exists under administration should not in any way be altered, reduced or jeopardized. It should be ensured that the scope of any carve out covers, but is not limited to, those areas protected under Article 3 Set Off and Netting, Art 6 Capital Markets and Art 7 Financial Markets of The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 and any collateral arrangements and settlement finality protections relied upon by participants in payment and settlement systems. Enabling parties to net out and close derivatives contracts such as futures, forwards, repos and swaps upon a counterparty's insolvency as quickly and effectively as possible is paramount to preventing paralysis in the financial markets.

Equally legal certainty in relation to immediate enforceability of collateral arrangements and the finality of payments and transfers in payment and settlement systems is critical to continued confidence of participants in such systems. The creation of any SAR should be explicit in that it does not affect such arrangements between the insolvent firm and its counterparties.

We also suggest that the objective of business continuity could be strengthened by recognising that notwithstanding a global firm's multi-layered, multi-jurisdictional holding company structure, it is likely to operate functionally as a single entity.

In terms of other supporting levers to assist in achieving an orderly resolution process for a failed investment, our members would highlight the following key areas:

- clear guidelines for insolvency officials and courts, particularly relating to the recovery and allocation of client assets;
- a framework for managing the inevitable cross jurisdictional issues arising from the failure of an investment firm;
- information sharing, access and cooperation between insolvency officials, regulators, client asset owners and other relevant parties to ensure transparency in the actions taken by insolvency officials in implementing the resolution process;
- expedited court process providing appropriate notice and hearing opportunities to relevant stakeholders, and record creation for purposes of ensuring transparency and developing legal precedent.

Q 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 administrator's actions in pursuit of the SAOs?

We see arguments on both sides for providing an additional defence to administrators from personal liability. On the one hand, it may well increase the speed of administrators' actions. Moreover, the scope of liability posed by a financial institution is increasingly likely to be inappropriately disproportionate to any one individual's ability to meet or mitigate such liability.

On the other hand, it may be undesirable to reduce administrators' accountability particularly for non-top tier administrators engaged in smaller investment firm insolvencies. The debilitating effect of the administrators' personal liability may be mitigated by the effect of all the other measures that the Government is proposing, such as the record keeping requirements in relation to client assets. It may be that the best counter balance to an administrator's actions (or inactions) is an expedited court process. Judicial involvement in the administrator's extraordinary actions could allow the winding down to proceed in the clear light of transparency with the assurances that are provided by the judicial checks and balances of notice, opportunity to be heard and appeal rights.

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

Our members think it would be useful to clarify that administrators' liability is no more than the directors before the company became insolvent. To this end, it might be helpful to spell out what the standards are.

Q 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?

Our members support an expedited court process; such process should consist of specialised insolvency courts run by judges experienced in complex insolvencies. The judicial process should be fully transparent and involve notice to, and opportunity to be heard by, all relevant stakeholders.

Q 6 Is there any other approach that the Government could consider with respect to the modification of administrator liability for the purposes of the SAR for investment firms?

See responses to questions 3 and 5.

Q 7 Do you agree with the Government's approach to proving 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 financial stability? What specific modifications could the Government consider applying?

Our members would generally support providing a defence from liability under section 214 of the Insolvency Act (for failing to put the firm into administration or liquidation at the point where they knew or ought to have known there was no reasonable prospect of recovery), where the directors are able to satisfy the court that their actions were taken pursuant to recovery and resolution plans agreed with the Tripartite authorities.

Q 8 Do you agree with the proposals for the initiation and scope of the SAR for investment firms and its interaction with the provisions of Part 2 of the Banking Act 2009, as described in Box 2A?

We generally support the scope of the SAR. As to the FSA's authority to initiate a SAR where the institution has the potential to affect the stability of the UK's financial system, we query what guidelines there would be for regulators to identify systemic instability. We would therefore suggest that, to the extent that the SAR is implemented, it should extend to all firms which provide a combination of custody and execution services, in accordance with the definition of an "investment bank" proposed in Chapter 1.

As for the interaction with the SAR and the Banking Act 2009 the proposals appear to be broadly sensible, however, we would query how the rules for investment firms and deposit-taking banks will interact in practice. We note that there are a number of further consultations expected from HM Treasury and the FSA. This Consultation Paper also makes reference to a Memorandum of Understanding among Authorities. Without these documents it is not possible to give a detailed commentary. Some members are concerned that the applicability of multiple regimes and lack of clarity as to their exact roles will increase market uncertainty upon a firm's collapse.

We would also seek further detail on the decision-making process, mechanism and timing for the Authorities to stand down post the administrator fulfilling the 'depositor-payout' obligation.

Q 9 Is there a case for considering provisions in the SAR 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?

Securing third party funding in the lead up to and post-insolvency is extremely challenging due to the critical role played by market confidence in the perceived solvency of financial institutions. Other obstacles to obtaining debt financing that are difficult (and often impossible) to overcome are the likely absence of unencumbered assets over which to grant a charge and the potential void ability of preferential transactions under s239 Insolvency Act 1986 (particularly where some counterparties get closed out and others do not).

Regarding intra-day support, we would appreciate more clarity on the government's proposal.

Q 10 The Government considers the costs to market participants of implementing the special administrative 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

It remains difficult at this stage to assess the cost. Aspects such as contractual adjustments of trigger events such as bankruptcy could be considerable. Detailed Cost benefit analysis is outside of the scope of this response.

Q 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.

If the Government communicates with the market about a failing firm and expresses anything other than the Government's full and unconditional support, then this would make the firm's eventual failure a racing certainty. Clients will terminate their contracts and the firm will fail. The focus should be on clear communication immediately upon the firm's appointment of administrators, but not before. Our members, therefore, support a clear communication role for the Authorities following the failure of a firm.

To ensure that any communication from the Authorities to the market supports the continued orderly operation of the market, following the insolvency of a firm, any communication from the Authorities will need to set out:

- a clear statement of the role of the Authorities;
- the channel for such information which could be in the form of a press release;
- the engagement of the Authorities with the investment firm and its wider group whether in or outside the UK; and
- a point of contact at the relevant Authorities.

Q 12 The Government considers the costs to market participants of a resource centre providing best practice guidance to administrators, and plans for coordinated market communication in the event of investment firm failure to be negligible, as these would require no market action.

Our members do not support the creation of a dedicated resource centre for administrators. It is not clear why established professional service firms with qualified insolvency practitioners need a publicly funded resource centre to carry out their role as administrators. We believe the costs for the establishment, and staffing and other ongoing costs of a resource centre will not deliver a commensurate benefit and would be better deployed in ensuring the expedited court process for failed firms is adequately established and supported.

Q 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?

Our members support the general principle that international entities should have the right to "opt in" in circumstances where they would otherwise fall outside the scope of any arrangements implemented as a result of the Government's work arising from this Consultation Paper. Our members query:

- whether the "opt in" would apply to all or a limited number of the proposed initiatives that are currently contemplated;
- the nature of any "opt in"; and
- whether UK institutions located in other jurisdictions would have the freedom to opt into equivalent regimes under such other jurisdictions.

The key issue is that there be clarity as to any opt-in regime as well as on other regulatory regimes and initiatives within the European Union (and Switzerland) and/or the wider global financial environment. Any optional opt-in should not jeopardise the concept of legal certainty or create a conflict of laws issue with the insolvency laws of the home jurisdiction of the institution. The investment firm and its counterparties should always be in a position to determine the relevant legal framework that would apply to the insolvent firm's resolution arrangements. We understand HM Treasury is doing further work in this area and we would welcome the opportunity to work with you on these cross border issues.

Q 14 Are there any other specific issues in relation to cross border investment firms, not considered here or in Chapter 8, that need to be addressed?

The proposals consistently raise issues in respect of how such proposals will work in the context of cross border investment firms. The very nature of cross border investment firms gives rise to identifiable complexities across a whole range of issues including:

- resolution planning and implementation (including key supplier and staff issues) as contemplated by Chapter 3;
- cross border intra-group custodian arrangements; and
- cross border affiliate asset holding arrangements.

While we understand HM Treasury's proposals with regard to cross-border insolvency, promoting cooperation, coordination and communication is absolutely essential. We further suggest that the Authorities consider the development a COMI (centre of main interest) treaty with countries outside the EU, in order to avoid the development of competing parallel insolvency proceedings in different jurisdictions.

Q 15 The Government welcomes views on the extent to which the package of measures proposed in Chapters 2 and 3 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 scheme for investment banks?

We believe that the combination of the SAR and resolution planning should go a considerable ways toward providing for greater continuity and more orderly wind-downs, particularly if the scope of the creditor moratorium under administration could be extended to non-financial contracts.

Before responding to the question relating to a special resolution regime, we would like the benefit of more detailed proposals.

Requiring firms to manage for failure – Chapter 3

Our members support the need for recovery and resolution plans to enhance the ability of failing firms to exit the market in a way that minimises market and systemic disruption and would propose that the following structure is considered:

- recovery and resolution planning, BIPS and BROs should be viewed as being part of a Group wide strategy as the issues and associated information that will need to be considered in such planning will be drawn from the wider Group including, in many cases, non-UK based activities of the Group.
- A principle of materiality should ensure that plans focus on matters of criticality from a group perspective.
- In support of this approach we would also suggest that:
    - the risk profile of the group should inform the demands on the recovery plan of a firm. Strategic actions in a recovery plan should remain generic rather than specific as the nature of a particular crisis cannot be predicted and there will be uncertainty and complexity around applicable laws, regulations and stakeholder reactions. Recovery plans should be seen as a menu of options rather than as a determinative solution to a specific stress scenario;
    - resolution plans should contain explicit details on the composition of the Crisis Management group of the College of Regulators ("CMG") that would act in crisis situations and an agreed approach and protocols that would operate to create a 'common language' on how the CMG would deal with crisis situations;
    - to ensure that such planning is fit for purpose, there is a need for a degree of flexibility to enable institutions to adopt plans that fit the particular business model and operational arrangements of the firm in question. The Authorities should seek to have only one resolution plan for a firm group-wide (with appropriate adaptation for legal entity and international specifics) as otherwise there would likely be inconsistency and incompatibility of objectives and approach.

Our members would also advocate that the focus of the planning should be proportionate to the risk profile of a firm and relate to the parts of the institution's business that are significant. There will be a different focus for each institution.

Our members would also draw HM Treasury's attention to the overlap between its proposals and a number of other existing compliance regimes and ongoing regulatory consultations in the UK (in particular with the FSA's pilot involving large international banks to prepare recovery and resolution plans), the European Union and on a global basis. Our members would particularly draw the Government's attention to the overlap with the issues highlighted in the AFME response to EC Framework for Cross Border Crisis Management in the Banking Industry dated 29 January 2010.

Q 16 Do you have any views on the coverage or detail of the BRO's responsibilities as outlined here? Are these consistent or compatible with existing template for the corporate governance structure of firms?

Our members support the principle of a BRO who would have a coordinating role and broadly agree with the broad scope of their responsibilities as outlined in paragraphs 3.15 -3.17.

The role of the BRO should be one of coordination within the investment firm to ensure that the relevant information is being compiled, with the BRO serving as a point of contact in a business as usual and distressed environment for the FSA in respect of recovery and resolution planning and for the administrator in respect of the BIP once the SAR is initiated. Any attempt to impose a detailed and prescriptive set of rules and reporting requirements that would apply across the board to all firms will result in a BRO being required to implement resolution and recovery plans that are not appropriately tailored to their own financial institution.

The role should be principle driven with the BRO identifying the key information for the significant business units of a group that merit a recovery and resolution planning. The role of the BRO should not be to carry out a root and branch data collation exercise to cover every business activity but rather a functionally useful "business operation manual".

In addition there is a need to minimise any overlap between:

- other existing risk management measures; and
- the impact of other proposals in this Consultation and other Government and international initiatives.

Turning to the specific policy actions outlined in Box 3B, we broadly support the identified actions, with the following observations:

- **investment firm resolution plans:** Having a BRO as a key contact point is supported. For resolution plans, the FSA regulations will need to allow flexibility to ensure that they are fit for purpose within a particular institution.
- **business information packs ("BIPs"):** For BIPs, the level of regulatory scrutiny should be proportionate; the review and approval of the BIP should primarily be for the Board with oversight by the FSA rather than subject to frequent and ongoing audit by the FSA. In particular a balance needs to be struck between the level of data collation required in a BIP and its usefulness. The BIP should act as a "road map" for the BRO and an Administrator to locate key information and personnel relating to the activities of a failed investment firm. The BIP should not attempt to be a perfect facsimile of all

relevant information within the investment firm or its wider Group; any attempt to establish such an arrangement will fail and will also result in an unwieldy data set that will in all likelihood hinder rather than assist in any resolution process.

- **business continuity - staff:** the ability to fund the retention of key staff will be necessary as will the identification of appropriate contractual terms.
- **business continuity – suppliers:**
  - responsibility of BRO to identify key contracts need to be set at a realistic level to ensure that the focus of BIPs is proportionate;
  - ensuring continuity of intra-group and third party suppliers, could be achieved by extending the scope of the creditor moratorium under administration
- **operational reserves:** We note that the proposal does not set out any clear parameters for the nature, size and treatment of the proposed operational reserve. Whilst we support, in principle, the establishment of an operational reserve, it should not be duplicative of pre-existing reserve requirements and if adopted, should count toward current regulatory capital requirements.

In particular, more detail is required in respect of the proposals relating to operational reserves including:

- how is the reserve sized, how frequently is the reserve calculated/adjusted and in each case by whom;
- what will be the nature of the provisions for reserve (cash/cash equivalents/other) and where can the reserve be held?
- what will be the regulatory capital and accounting treatment of the reserve, including under FSA Pillar 2 capital requirements?
- impact of administration/insolvency on access to funds. Should funds be available to directors during any delay (formal moratorium or otherwise) in the appointment of an administrator?
- what is the scope of the operational reserve? What is its territorial, legal entity, and business capabilities application, e.g. local management committees, outsourced service providers (group-owned or independent)?

Q 17 Do you agree with the basic policy of establishing a role for business resolution officers 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?

Our members support the policy of establishing a BRO role in investment firms and agree that such a role could be an effective way for both investment firms and the FSA to ensure that recovery and resolution planning are put in place and kept up to dates effectively. It is worth clarifying, however, that responsibility for recovery and resolution planning and BIPS should remain that of the firm and the full board of directors and that the firm should bear any sanctions for any failings in this area, and not the BRO.

Q 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?

It could be useful for the BRO to be an existing member of the board who would in addition perform a co-ordination role (as described above) in respect of recovery and resolution planning and the creating and updating of the BIPs. It is likely that each financial institution group will have a single BRO for its UK operations rather than a BRO for each relevant investment firm within its group. Other firms' organisational structures, on the other hand, may necessitate more than one BRO.

In terms of the nature of the BRO, we would anticipate that the BRO will:

- be supported by a team, subject to the size and complexity of the firm;
- have as its focus a co-ordinating role to ensure that the appropriate information is collated, maintained and accessible to an insolvency official and/or the Authorities;
- ensure that any reporting needs to be aligned with existing reporting to avoid any overlap or duplication (and be supported by the FSA in taking such steps); and
- liaise with Authorities to agree the scope and level of detail of the relevant plans.

However, we are concerned that too much emphasis may be placed on the role of the BRO and the language used may place unreasonable expectations (and liability) on the BRO's shoulders. By way of example, it is probably too much to place a requirement on the BRO to ensure that appropriate insolvency-proof contracts are in place with suppliers, bearing in mind the legal and practical issues involved. Whilst the BRO will have an important role, we believe that the BRO is unlikely to have quite the pre-eminent role envisaged by the proposals in the run-up to failure. Immediately prior to an insolvency event, the firm will continue to be run collectively by the board and senior management rather than coordination and decision making being delegated to the BRO. Following an insolvency event, management's role will be superseded by an administrator (or equivalent) with the result that the board and the BRO will neither have the power nor should they be subject to a legal duty to oversee the implementation of any resolution plans as the proposals suggest.

Q 19 Cost benefit analysis.

Detailed cost benefit analysis is outside of the scope of this response.

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

We believe the proposals are unrealistic in relation to internal facing actions in advance of administration as even some seemingly innocuous functions such as moving to daily reconciliations risks alerting external market participants if the distressed firm does not already perform such functions as a matter of course. Any signal to the market would exacerbate the difficulty of clearing banks to continue to make credit lines available to a weak institution.

Q 21 What are the obstacles to implementing investment firm resolution plans as suggested in this paper? What policies could the Government consider to address these, if any?

The key obstacles to implementation are:

- Funding;
- The impact of insolvency on the termination of contractual arrangements and the challenge of renegotiating key staff and supplier contracts;
- Conflicts among resolution regimes;
- Cross border issues in respect of access to group wide systems and information; and
- The size and management of operational reserves.

Q 22 Cost Benefit Analysis

Detailed cost benefit analysis is outside of the scope of this response.

Q 23 What resources do you expect the entire investment banking business of the firm to spend on resolution plan implementation?

Implementing a resolution plan is likely to take an extensive amount and broad in range of external and internal resources, consisting of personnel, technology and possibly consultants, and is somewhat difficult to quantify.

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

Our members support the policy objectives underlying the BIPs and agree that having a structured and maintained information source in place prior to insolvency will be useful for both administrators and other parties working to assist in a managed wind down of an investment firm. In practice, a BIP should be considered as an extension of normal crisis management rather than a separate and self standing arrangement.

It should be noted that how BIPs are constructed and maintained will be critical to their success. We would suggest the following:

- prior to directors recognising that the investment firm may be in trouble the BIPs should be a high level data "road-map" identifying the source and ownership of key information;
- if the directors/authorities are of the view that the investment firm may be facing difficulties, the BIPs could be upgraded to contain an additional level of centralised information; and
- the update and maintenance of BIPs should be a function of internal corporate governance with the reporting of the BIPs to the Board and a compliance related confirmation to the Authorities.

We are concerned that the approach outlined in Boxes 3D-3I is overly detailed and would require the rigid adherence to a prescriptive data set. There is a risk that in taking an overly detailed and prescriptive approach, the BIP data requirements will be too rigid to enable each investment firm to produce an appropriate BIP for the required parts of its business.

BIPs will only be effective if they are a useful and accessible resource for administrators. Experience from Lehman points to the need for effective information road maps and clear guidance on the source of key information and key decision makers. Centralising all information in a physical or virtual data room will result in a complex and unworkable data set that will inevitably be out of date in a number of material areas if BIPs are constantly trying to catch up with the dynamic nature of the underlying business.

It is recognised however that appropriate linking of a resolution plan to up to date versions of key documents and owners will enable the administrator to take informed actions.

- **3D Business structure**:
    - is there a natural limit to the level of detail? It would seem that the current proposal would be hugely complex to comply with;
    - if there are numerous subsidiaries across the international group this will be an impossible task to accurately compile and update.

- **3E: Business information and risk management**:
    - this requirement assumes that there is a central repository/ a limited number of sources for business information;
    - is a centralised and complete record of account numbers/the firms exposure and if not can this be practically achieved?
    - Data protection, bank secrecy, software licensing and regulatory action may present significant difficulties.

- **3F: Business strategy and risk management**:
    - Again, the level of detail is critical;
    - Are decision trees the appropriate form for such information?

- **3G: Personnel:**
    - Who is "key personnel";
    - Frequency of update?

- **3H: key operational costs and logistical information:**
    - Again, the level of detail is critical;
    - Is there a centralised repository for such information;
    - what should be the frequency of updates?
    - Is it necessary/desirable to distinguish between intra-group vs. third party arrangements.

- **3I: funding and liquidity:**
    - Funding and liquidity plans would be better considered in the context of recovery plans rather than resolution plans.

Q 25 Cost benefit analysis.

Detailed cost benefit analysis is outside of the scope of this response.

Q 26 What resources do you expect the entire investment banking business of the firm to spend on BIPs implementation?

See response to question 23.

Q 27 The Government would welcome views on what incentives and disincentives are likely to be effective and whether there are any concerns with the ones suggested above?

We recognise that retaining key staff in a post insolvency environment is critical to implementing an orderly wind down of a failed investment firm. We note that there are three key issues that make establishing a framework for retaining key staff potentially complex:

- current employment law issues;
- dual-hatting, secondments, or other sharing of resources between legal entities; and

- key staff that are employed on non English/Scottish law employment contracts.

We broadly support the suggestion of retaining key staff through retention bonuses; it is not clear from the current proposal set out in the Consultation Paper whether such bonuses would be covered as part of the operational reserve.

We do not believe that the level of such bonuses and the staff to which such incentives would apply can practically be pre-determined. The cost and complexity of reviewing and amending all relevant employee contracts including negotiating revised remuneration does not appear to support a straightforward or cost effective proposal for delivering continuity of key staff.

Q 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?

Our members support the approach identified by the Government of identifying key staff by key business activities within an investment firm or its wider group. The identification of key staff by business area/activities will vary on an investment firm by investment firm basis; there is no generic operating model and any attempt to formulate a single industry wide list of business areas and activities will not result in an effective identification of key staff at each investment firm.

We would propose that the identification of key staff should be a function of the BIP disclosure (see Box 3G) rather than staff identified from a generic investment firm wide list of roles and activities. In addition, the approach will need to be dynamic rather than static as some areas and activities increase in importance whilst others become less key.

Provided that there is flexibility in implementation, the areas identified in Box 3K appear to be a comprehensive list of business areas and activities. Please note for the sake of clarity that we read "market infrastructure" as including clearing and settlement, treasury operations and reconciliation.

In addition the identification of key staff located outside of the UK should also be considered to ensure that continuity issues do not arise as a result of the cross border nature of a group with key staff falling outside the UK regime.

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

As we suggest in our response to question 2 above, a good way to ensure suppliers do not try to extract preferential terms as an inducement to not exercise their contractual termination rights upon a counterparty's insolvency is to extend the scope of the moratorium on creditor action that currently exists under administration. AFME / EHYA, a division of AFME, discussed the destabilising effect these clauses can have in an insolvency in its response to the Insolvency Service's Consultation on Company Rescue on 7 September 2009. The response can be found at http://www.afme.eu/document.aspx?id=2682.

Q 31 What alternative policy tools 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 on this proposal?

We believe the objectives of continuity of essential services could be achieved by the expansion of the creditor moratorium under administration to non-financial contracts (provided such suppliers are paid on a current basis).

We also note that if requirements turn out to be cumbersome such as on the need to maintain BIPs or the cost of an operational reserve then firms not subject to such requirements in different jurisdictions may enjoy a competitive advantage.

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

An administrator should use the operational reserve only for operational expenses.

Q 34 Do you have any views about the operational reserve proposed in Chapter 3?

See responses to questions 16 and 32.

ANNEX 2: Response to Questions raised in the Consultation Paper (Chapters 4 and following)

Reconciling and returning client property – Chapter 4

Q 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 client's entitlement to their assets should be calculated?

Clarity over shortfalls

We agree that it would be helpful for all relevant market participants to have clarity over the treatment of shortfalls in client asset omnibus accounts on insolvency.

In this context, we are aware that the FSA will shortly publish a consultation paper reviewing the CASS regime and we anticipate that the issues relating to client asset omnibus accounts, as well as client money omnibus accounts, will be considered as part of this process. The outcome and feedback on the consultation will form the basis of any changes, whether they were to take the form of industry-led initiatives, regulation, legislation or some combination thereof.

We support industry-led moves for greater clarity in documentation, and investor education before legislative measures are considered. It is noteworthy to indicate that the use of omnibus accounts are mainly driven by efficiency and cost optimisation reasons, which ultimately benefit the end investor.

There should, therefore, be a market driven solution to the allocation of shortfalls:

- clients have the ability to request to have individual segregated accounts at their option;
- in the event a client declines to take individual segregated accounts for any of its various asset classes it will need to be made aware that the client omnibus account which holds its assets will bear any shortfall on a pro rata basis

Clients should not be obliged to take up segregated account arrangements unless it is identified that a particular group of investors (i.e. retail funds and UCITS funds) may require special protections. Firms should not be under any regulatory obligation to offer segregated individual client accounts; and the maintenance of such accounts entails financial and operational burdens which could be significant and imply additional costs for clients. Segregated individual client accounts can also increase operational risk.

We also note that there is currently international action in respect of client accounts under the Geneva Securities Convention. We would question the merit in the UK applying a specific set of client allocation rules which may be inconsistent with a pan-European approach to be adopted under the Geneva Securities Convention.

Clarity over a client's entitlement to their assets

We support the proposal that the Government provide clarity over when client's entitlement to their assets should be calculated. To provide certainty as to the timing of when a client's entitlement to their assets should be calculated the date and time of the Court Order appointing the Administrator should be used as the fixed point of reference. To minimise the numbers of trades that could be entered into on the day of the Court Order, there should be a policy of ensuring that the Court Order is made as early as possible on the relevant day.

It should be noted that picking any other arbitrary cut off time or date (such as close of business or midnight the day before the Court order is made) is likely to bring added confusion as trading and settlement occurs on a global basis.

Access to compensation schemes

As these proposals are developed, it will be important to ensure that investors' access to existing compensation schemes is well understood and that there is alignment between the new proposals and the compensation scheme rules.

Q 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?

A market led approach to product warnings

We agree that mandated risk warnings would be helpful but only where they were targeted accurately. We would support industry-led initiatives to develop high-level market-wide risk warnings on a product by product basis to allow tailored approaches. Moreover, we suggest that central counterparties might also contribute to better transparency through improved disclosures.

In terms of the proposal that clients are offered designated named accounts at custodians, we support a market driven solution rather than a legislative or regulatory requirement; we believe that a market led solution will be best placed to address the very different types of risks arising from rehypothecation and omnibus accounts. We are concerned to ensure, in particular, that there should be no attempt to address the issues raised by these the two very different legal arrangements with a single, regulatory approach. In particular, it is essential to recognise that:

- risk warnings on rehypothecation, which will always involve the transfer of assets, should focus on how to make clear to clients the nature of rehypothecation and seek to ensure that clients understand the agreement into which they are entering.

- risk warnings around client omnibus accounts should focus on explaining and managing implications upon insolvency.

We would also highlight that implicit in adoption of risk-warning requirements is the creation of greater regulatory and legal certainty over the contents and distribution of the client money pools.

As part of good market practice, appropriate warnings should be part of the arrangements with the direct counterparty; and there should be no obligation to look behind professional managers or other intermediaries.

It goes without saying that risk warnings are not a substitute for the taking of professional advice by clients in relation to contractual arrangements.

Designated named accounts at custodians

Firms should not, however, be required to provide clients with designated named accounts at custodians. Instead, current arrangements meet market needs; a client may agree as a matter of private contract with a firm that its assets be held in designated named accounts at a custodian. This flexibility ensures client choices are maximised.

In practice, it will not be necessary, practical or economic for every client to adopt named designated accounts with every custodian. Clients may wish to invest in a number of different asset types for different periods of time depending on their changing operating and investment strategies. It would not be practical or efficient for the market (both clients and custodians) if every time a client wished to enter into a new asset class trade or investment a new named account had to be created.

If a client has a particular requirement for a designated named account it has the ability to negotiate such an arrangement with a custodian in accordance with general market practice.

We are of the view that a market-wide requirement that all clients maintain designated named accounts at custodians is likely to have negative economic consequences including:

- imposing substantial additional costs on market participants;
- reducing liquidity; and
- limiting financing.

It is worth noting that the small number of markets where designated named accounts at custodians have to date been the standard, are now tending to move away from named accounts to the omnibus approach, apparently in moves to attract more international investors. These include certain Scandinavian futures markets such as Nasdaq OMX. This suggests that a requirement to provide segregated individual client accounts may adversely affect the UK's competitiveness as a hub for international securities finance.

In this context, it is noteworthy that securities holdings are maintained through different levels of financial intermediaries. For example, private investors may hold assets with an asset manager (acting for a fund or legal vehicle), who in turn holds them with an affiliated custodian, who holds them with a global custodian, who holds them across markets with local agents, who hold the final CSD accounts. The proper functioning of this is only possible through the use of omnibus accounts at the intermediaries' levels. Provided the two key conditions are maintained (segregation and record-keeping), there is no reason to change this structure, which works well. On the contrary, requiring segregation down from the beneficial owner level to local depositories would require the opening and maintenance of millions of accounts at all intermediary levels, which would substantially increase operational risk and costs and reduce liquidity.

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

The overarching objective of clarity in contractual arrangements is supported. We suggest that industry led initiative may be the best medium for obtaining standardisation on the terminology of certain key contractual provisions. We are reticent to encourage prescriptive Governmental contractual drafting, which would not reflect the commercial and risk factors between the parties nor reflect the idiosyncratic platforms that exist across investment firms/ banks. We see value in identifying opportunities where an industry standard would be appropriate and establish certain core industry standard terms via an industry-led initiative.

In particular, it is agreed that competitive disciplines within the market will drive any necessary contractual changes. We firmly support the view set out in paragraphs 4.41 – 4.45 of the Consultation Paper that market practice and the support of trade associations in driving market practice is the correct and proportionate approach to delivering clarity in contractual arrangements including:

- **CASS:** paragraph 4.41 of the Consultation Paper refers to the effect of CASS and the ability of market participants effectively to opt out of CASS where they choose to do so. Market participants are aided in deciding whether to do so by appropriate disclosures and risk warnings;
- **Set off and liens:** as referred to in paragraphs 4.42-4.43 of the Consultation Paper, contractual flexibility and choice around the impact of set off and liens to enable contractual arrangements to meet specific client needs is desirable. It is agreed that it would not be appropriate or assist in the efficient operation of the market to remove such commercial flexibility. It is expected that market forces will drive the appropriate level of notification and understanding of set off arrangements; there is no clear requirement for any Government intervention in this area. Local custodians (assuming any relevant proposals are not defeated by cross-border legal issues) still need recourse to assets for their fee, which may be secured by lien and set-off arrangements over any

proprietary assets of prime brokers or investment firms held at the local custodian.

It must be wrong in principle for a custodian to take a lien or right of set-off over client assets in relation to fees due from the prime broker, investment firm or custodian in respect of its own activities. We believe an internationally co-ordinated approach to this issue is required.

This however, does not address the problem for global custodians arising when they offer contractual settlement to clients or CCPs are used. Therefore, although it would be helpful, we recognise it may not be commercial or operationally possible to relinquish rights of set-off and liens held by custodians or sub-custodian in local markets or at CCPs. We are, however, confident that market forces with industry guidance will compel change where possible and appropriate notification where not.

- **Event of default arrangements:** as referred to in paragraphs 4.44-4.45 of the Consultation Paper, the market is already addressing the failure of certain contractual arrangements to provide for the possible default of their investment firm (see for example the AFME Protocol and the proposals referred to in paragraphs 6.81-6.88 of the Consultation Paper). Given the current market activity in this area and the recognition by market participants that investment firm failure needs to be addressed as part of contractual arrangements there is no clear requirement for any Government intervention in this area.

Q 38 Internal 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 per 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.

Cost analysis is outside the scope of the AFME response. However, the response to this question will only be relevant if the format of warnings is imposed rather than agreed via market driven initiatives.

Whilst mandatory warnings are supported in principle (see our response to Question 36 above), it should be noted that our support is predicated on the assumption that the warnings will be high level and generic rather than product-focused. Any requirement to tailor warnings to specific products should not be necessary as investors are really concerned with an appreciation of the risks affecting their assets.

We would also like to highlight that the Government’s assessment of costs is likely to be an underestimate of actual real costs to an organisation of implementing mandatory warnings. The figures suggested by the Government have a very narrow focus being focused purely on an external legal fee basis and failing to take into account:

- Internal operational costs;
- The group-wide costs if warnings have to be adopted and reviewed by more than one investment firm within a group;
- The cost of re-documenting all client relationships (though this would be less if the risk warnings were 'one way', not requiring explicit acknowledgement by the client).

We note also that this cost estimate appears to be based on the premise that risk warnings would take the form of a high level warning. However, as London acts as a global hub for many markets, the actual cost of risk warnings tailored by product and market is likely to be exponentially higher than this estimate. For example, the question of whether or not a client receives segregation at a given CCP within the CASS sense will depend on the structure of the market at a given CCP as well as its legal and regulatory regime. A meaningful risk warning about the nature of its protection is thus likely to be specific to that particular CCP. Instead, in our view a more efficient and appropriate goal is the development via industry-led initiatives, of high level risk warnings on a product by product basis. We would reiterate our comments, provided above to the Question 37. Of course, clients will need to take their own advice about the legal risks arising.

Q 39 Do you agree with the Government's proposals 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?

These proposed reporting requirements will potentially involve systems development across a number of business units and it is essential that adequate time be given between the time when the requirements are finalised and the date when they come into effect to allow this work to be carried out efficiently and safely.

We feel that restriction of the requirement to systemically important firms may not always be the best test because clients' assets should receive the same level of protection, whether held at a systemically important firm or not. We note that paragraphs 4.48-4.54 of the Consultation Paper address the requirement of reporting to:

- benefit client transparency; and
- assist regulators and insolvency officials.

We consider the existing requirements adequate and therefore the focus should be on adherence to the existing requirements rather than an introduction of new requirements. We also consider that reporting requirements should apply to all relevant investment firms and not discriminate between firms, but the level of reporting should be determined by the nature of a firm's activities.

It is important that all firms with Part IV permission to conduct a particular business should be treated equally.

However, should increased reporting be determined to be of benefit, the driving principles should be those noted in paragraphs 4.48-4.54 of the Consultation Paper: enhanced reporting identified as necessary to benefit client transparency and enhanced reporting identified as necessary to assist regulators and insolvency officials.

We support these twin objectives but would caution that setting the right level of reporting is critical to actually achieving these objectives. A requirement for excessive or unnecessary information will have the effect of diluting the effectiveness of the reporting and failing to meet the information needs of clients, regulators and insolvency officials by creating a lack of clarity.

We propose that to assist transparency the level and frequency of reporting should be set at a level where any report:

- assists rather than overwhelms client understanding of their asset positions (in this context less really can be more);
- is at a frequency that meets the particular needs of a client;
- enables investment firms to utilise their existing approach to data (such as intra-group netting arrangements) rather than a prescriptive approach to reporting.

One point to be considered is the usefulness of pre-insolvency reports and valuations in a post-insolvency environment. If the market for assets has become illiquid, the pre-insolvency positions may not be of significant assistance to an Administrator. The value of enhanced client asset reporting links directly to the continuity of business issues is highlighted in our response to Chapter 2. We would question the requirement to provide a "true" net intra-group security interest liability figure. This is a very complex analysis and of limited value as the client's exposure can change significantly intra day as margin calls are met. A static identifier of the areas or arrangements or products which have recourse to the assets (via set-off or security interest) may be more helpful to the administrator upon an insolvency. Such an identifier should not, of course, amount to an additional requirement to perfect a security interest.

It should also be noted that client asset owners have a good understanding of their risk management positions at any given time and such data will be useful in assisting an Administrator.

In establishing an effective reporting regime, the following points will need to be carefully considered:

- **Who will the reporting duty apply to:** Consideration needs to be given as to who the requirement will apply to. Paragraphs 4.48-4.49 of the Consultation Paper refer to "investment firms" which is broadly acceptable. However, in line with the overarching objectives of the Consultation Paper any reporting requirements will need to be implemented proportionately to ensure that the reporting requirements are fit for purpose and not overly burdensome on either investment firms or clients

- **Level of reporting: Box 4D**
  - **Detail of data:** To ensure that reporting requirements deliver a meaningful and functionally useful data set to assist clients and to support the understanding of client asset positions within a systemic investment firm on an insolvency, the data should be focused on key data areas.
  - **Treatment of Static vs Dynamic Data:** Reporting can be split between "static" and "dynamic" information. Static information should be reported once and only updated on a change in treatment/approach (for example whether client omnibus or client designated accounts are used). Reports should only set out key dynamic changes in asset positions from previous reports.
  - **Frequency of reporting:** clients should be able to contractually elect the frequency on which they receive reports; daily reporting may not be required by clients. The frequency of reporting to clients will not affect the underlying data held by the firm that in accordance with the proposals of chapter 2 should have accurate data on daily basis of client positions.

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

We wholly support the requirement for accurate client record keeping, which are set out in the existing CASS regime, in particular CASS 6, 7 and 8. Efforts should therefore be focused on adherence to those rules, rather than an introduction of new requirements. We strongly support the existing application of the relevant CASS rules, to *all* regulated firms with Part IV permission to hold client money and assets rather than simply to one class of firm. Record keeping requirements should be uniform to all participants in a particular regulated activity**.**

We support the proposal for settlement record keeping as well as trade date record keeping. It is our understanding that the current practice in the industry for firms is to maintain records of both settlement date and trade date and therefore we do not consider it necessary to increase record-keeping requirements. We would welcome further clarification on the question.

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

The proposal is broadly supported subject to having an opportunity to review and comment on any proposals suggested by the FSA. We would welcome standardised reporting protocols to foster greater transparency and improve cost efficiency by identifying and analysing via industry-led initiative what information is needed by the public and how it should be presented in order to make such disclosure meaningful.

However, whilst we support better reporting to the FSA we do not believe that making such reports available to clients is necessary or helpful to clients and we do not support the release of audited client money and assets reports to clients; clients should only receive a confirmation that the audited reports have been received. We note that regulated firms with client money permission currently submit the external auditor's report to the regulators.

Q 42 Should the authorities clarify the scope of FSA CF-29 and centralise CASS oversight under one individual?

We note that the CASS Consultation has not yet been published and Question 42 will need to be re-considered in light of the outcome of the CASS Consultation. We support an industry-led initiative to examine the most appropriate group or entity level within a firm at which a CF29 should be appointed and the scope of their duties, including a power to delegate.

Q 43 Cost Benefit Analysis

As previously noted, cost benefit analysis is broadly outside the scope of the AFME response.

However, we would observe that the nature of any increased record-keeping requirements will drive the cost of systems changes necessary to meet them and the cost will differ firm by firm. The on-going annual costs of £30,000 appears to indicate the costs per firm and therefore the aggregate costs for the industry should be multiplied by the number of regulated firms in the UK. Moreover we believe that this estimate significantly underestimates the potential costs, given the complicated process adjustments that may be entailed.

Q 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?

We recognise that clients are interested in arrangements that isolate their assets from the effect of an investment bank failure and welcome Government support in assisting the market in developing solutions to the issues identified by clients.

We would note, however, that bankruptcy remote vehicles are only one of the models currently being developed by investment firms to meet client demands in this area. A number of market participants are currently working on proprietary structures to create a ring-fenced solution for client assets in the event of an investment firm insolvency; a bankruptcy remote SPV is only one of the proprietary models that is currently being explored and we would expect a competitive market in client focused solutions to develop over time.

It is therefore not appropriate for the Government to impose a single model on the market but encourage the development of proprietary models designed to meet market concerns and client demand. In particular the Government should avoid favouring any particular model as this would adversely impact the competitive market and narrow the options for clients.

Government support for a competitive market is welcomed and we anticipate that as the form of the various market-driven models are clarified, there will need to be a review of legislation and regulation to enable the new structures to operate effectively and meet client needs.

Q 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?

We support moves to enhance clarity on documentation for clients in relation to the potential legal implications of the transfer of assets to affiliates. However we do not support a prohibition on transfer of client money to affiliates.

We note also that clients like to have the ability to choose their general clearing member (GCM), so they understand that their chosen firm may use affiliated brokers. The use of affiliated brokers is a fundamental part of many trading functions (for example in the trading and clearing of exchange traded derivatives); it provides clients with flexibility and facilitates the meeting of regulatory requirements such as best execution. The use of affiliated banks should be a matter of contractual negotiation between firms and clients.

A proposal to limit the transfer of assets to jurisdictions where there are potential interoperability issues with CASS may inadvertently damage the London market. As London is a global hub, many clients active in foreign markets including emerging markets conduct business in London but those transactions often require booking or other operations in original jurisdictions. By limiting the rights of London firms to transfer client money to jurisdictions with potential interoperability issues, clients might opt to contract directly into those markets resulting in not only lower volumes in the London market but also potentially exposing clients to fewer protections than those from which they currently benefit.

In this regard, we should bear in mind that there are situations where client money has to be held locally (e.g. because of local law or regulation).

In relation to the use of affiliated banks to hold client money, we believe this should be a matter of contractual negotiation between the firm and the client. A restriction on holding client money with affiliated banks could have the unintended consequence that clients of affiliates of highly creditworthy banks would find their money deposited with a less creditworthy unaffiliated bank.

Q 46 Should firms that manage client assets be required to obtain letters from custodians stating that there are no setoff and liens over client assets in respect of liabilities owed in a principal capacity?

In principle we support the proposal for investment firms to request the provision of formal confirmation from a custodian that rights of set-off and liens only apply to client fees and that there are no rights of set-off and liens over client assets in respect of liabilities owed in a principal capacity provided that the requirement for such confirmations was limited to relevant situations and client custody accounts only. We understand that some firms obtain such confirmations for business rather than regulatory reasons.

However, before the requirement can be imposed:

- the Government and FSA will need to consider and implement a regulatory framework within which custodians would be required to deliver such confirmations
- a clear distinction will need to be made between "house" accounts where no confirmation is required and "client" accounts
- a timeframe needs to be identified for addressing existing arrangements with custodians or grandfathering arrangements need to be agreed.

In addition, the international ramifications will need to be carefully considered; due to the international "hub" nature of the London market, investment firms will have custodian relationships with non-UK custodians who will not be under the same regulatory framework. A UK requirement to obtain a confirmation from a non-UK custodian will be subject to the local laws and regulations applying to the custodian.

Particular issues we have identified include:

- where no lien is granted to a sub-custodian over customers' assets, the sub-custodian would need to turn for recourse to the Prime Broker/ Custodian (and its proprietary assets) for fees payable to the sub-custodian. We note, however, that this does present problems if there is no lien over client assets (and no proprietary assets) since the sub-custodian may have no recourse to assets held for its fees – and where sub-custodians offer contractual settlement or have trading exposure this is an unacceptable position for them to be in.
- making such a confirmation mandatory for firms may have the unintended effect of blocking clients' access to business opportunities in certain markets where there is little competition amongst available custodians. In such a case,

we would consider the preferred option would be to disclose to clients the custodian’s refusal to give up set-off and liens, rather than having to decline to provide the client access to the market.

- in the futures market it is usual for custodians supporting a central counterparty to take liens over client collateral (supporting client positions) and custodians supporting the central counterparty to maintain rights of set-off over pooled client margin collateral. Removing such rights is likely to weaken the ability of central counterparties to manage their risk.

Removing a custodian’s rights of set-off and lien could ultimately have the effect of driving up costs for the industry and end investors substantially. There is concern that these proposals might mean that custodians will no longer be able to offer contractual settlement, thereby decreasing the level of certainty offered to clients under the current ‘contractual settlement’ arrangements.

One area that will need to be clarified is what the consequence of not obtaining a confirmation in the appropriate form following a request from the relevant investment firm. If a custodian does not produce the required letter the consequence should be an obligation to disclose to the client the possible existence of contractual set-off rights and liens over client assets in respect of liabilities owed in a principal capacity; the client will be in a position to make an informed decision as to the risks it faces and can move to another custody account arrangement if it so chooses. There should not be any obligation to close accounts due to the lack of a custodian confirmation.

It goes without saying that such disclosures are not a substitute for the taking of professional advice by clients in relation to contractual arrangements.

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

Firms should not be required to have the capacity to pool client money relating to riskier activities separately because:

- it is not clear what the business benefit to all clients of such an obligation would be; and
- such an arrangement could limit the flexibility of services that could be offered to clients.

Ultimately such a requirement will result in additional costs being unnecessarily imposed on the market as a whole. In our view, this requirement would further complicate the client money regime with no appreciable benefit. Risk categorisation is a complex and potentially controversial issue, opening up an additional avenue for argument as clients argue over the perimeters of the individual sub-trusts of client assets based on the concept of risk. This may add to the delay in the calculation and return of client assets.

Efforts are better devoted to refining the current client money regime by addressing those gaps identified through recent market events, rather than by a material shift in approach through the introduction of categorisation by risk. We look forward to further discussing this proposal in the forthcoming review of the CASS regime.

Firms may wish to offer the service to clients voluntarily, where those clients see a benefit and the firm is able to provide the service.

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

Such a significant change (one that will impact client rights to trust assets) would require very careful thought and broad industry consensus. In our view there would need to be a careful balance in the imposition of bar dates, so that both speed of distribution of assets was achieved as well as the fair treatment of all entitled parties.

In this regard, detail is required in relation to the operation of an equitable "bar date". Limiting the beneficiaries of the trust's ability to claim their trust assets is a highly controversial position. Any application of a bar date must be applied with sufficient notice so that the contestant can make use of its rights. This provision weighs the expedient trust asset return against inhibiting the beneficiaries' rights to claim over their trust assets.

Again, the interplay with suspense accounts (retaining an amount for latent claims) and consent of the beneficiaries are key concepts which may help to make this proposal workable.

It would be better to grant a power rather than impose a duty, so that the use of a bar date would be subject to the oversight of the Court, as it is today.

Q 49 Cost Benefit Analysis

As previously noted, cost benefit analysis is broadly outside the scope of the AFME response.

However, we would observe that the approach taken by the Government to the cost-benefit-analysis raised in Question 49 takes into account of implementation costs but does not appear to discount on-going costs arising from negative implications. A lack of flexibility due to restriction on transfer to affiliates would need to be considered more carefully for globally active firms. A London-based firm's ability to offer a global service to clients would be negatively impacted on. There are broadly two issues:

- regarding limiting the transfer of client money to affiliates, we think this could have broader and ongoing implications given the hub model operated by many firms in London referenced earlier in our response and therefore costs are likely to be substantially higher than set out above.

- with respect to dividing client money into separate pools, the cost estimate numbers seem relatively low, particularly given the likelihood that many firms will be required to undertake system enhancements to facilitate such a separation.

Q 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 "futureproof" and do they have a limited negative impact?

We support the Government's emphasis on proposals which will enable investors and investment firms to agree improvements to client money and assets as a matter of contract or as industry-led initiatives rather than via additional regulation.

In addition, we believe the forthcoming FSA CASS review is an important step in reaching appropriately flexible and mutually acceptable outcomes.

Q 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?

The Government might want to consider whether issues arising from fraud or failure to segregate money due to systems and controls failure within the firm (that would have enjoyed the protection of CASS) could be addressed by more effective supervision by the FSA and improved cross-border interoperability among the Clearing Houses and CCPs for cash and assets transfers.

Providing clear and effective support for clients – Chapter 5

Most members do not support the creation of a client assets trustee (CAT) at this stage because they believe that the CAT as described would not necessarily speed up the return of client assets and they see a significant risk of additional costly litigation. Some members are attracted to the CAT in principle.

In the current insolvency regime, the conflict between the administrator's duties to creditors and its fiduciary duty to custody clients is inherent. The proposed special administration objectives help with this.

If the government decides to proceed with the CAT proposal, there is a case to be made on efficiency grounds for the CAT to be part of the administration team, rather than being separate – and separately resourced.

Q 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?

While there may be merits with respect to the appointment of a CAT, significantly more details are required in order to arrive at an informed view. Although some feel that a CAT may be able to tackle a key concern, namely the conflict faced by administrators dealing with client assets when also dealing with the claims of creditors, the Consultation Paper sets out sensible alternative measures and a combination of all or part of these measures may help to address the issue satisfactorily. Two examples are setting out a clear objective for an administrator to prioritise the return of client assets and client money and improving record keeping requirements. Citing a current example, it is not clear if returning client money and assets held by LBIE to clients would be faster, even if a CAT were acting for clients. It is our observation that a key issue was with poor record keeping by LBIE, which made identification of client money and assets very difficult. An emphasis on measures to improve compliance with record keeping duties will be very important.

If the CAT were to be introduced, the scope of application should not be limited to only a segment of investment firms, as a selective application may negatively impact market confidence in firms not subject to the CAT rules. The CAT should apply to all firms holding client assets, including banks. Without a level playing field, markets could be destabilised as clients might react to divert business away from the firms, to which the CAT regime does not apply, to the firms under the CAT regime.

Expanding on our commentary above, we feel it is probably preferable for the CAT to be appointed from the same insolvency practice as the administrator for efficiency and coordination reasons, which would reduce the costs for all stakeholders (clients, creditors and shareholders). We recognise that under this arrangement the independence of the CAT may be perceived to be compromised, however on balance it is probably more beneficial to have the CAT within the administration team.

Q 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?

If a CAT regime were to be introduced, a model where client assets remain vested in the company is our preferred option as it would be more aligned with the existing insolvency process, and would offer more flexibility with less uncertainty. In our view, there may be a risk that the administrator and the CAT are unable to agree on whether assets constitute clients assets or general pools, and therefore the model where client assets are vested in the CAT, may present an immediate problem and may give rise to increased risk of litigation. This is a particular area where more details are needed.

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

The running costs should probably not be borne out of the assets and money of the clients the CAT is acting on behalf of because this would likely slow down the return of assets since the costs would presumably need to be pro-rated which adds yet another process to be followed. Instead the costs should probably be borne out of the general estate particularly if the CAT is appointed within the administration team. An additional reason why the general estate rather than individual creditors should bear the cost of returning client assets, is that the firm (and therefore general creditors and shareholders) as a whole enjoys the benefits of revenue generated by the custody operation in the good times and therefore should bear the costs associated with unwinding the business in the bad times.

Q 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?

As emphasised above, whilst there are merits for the establishment of a CAT, we feel that more detail needs to be provided so that firms can clearly understand and comment upon the proposal more constructively. We also think that the Government should explore opportunities to study alternative measures as much as possible, such as amending the legal duties of administrators by setting out the SAOs in legislation.

This is one of a number of areas where the various proposals in the Consultation Paper interact and it will be important to review the final package of measures to ensure that the interactions are well-designed and effective.

Q 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.

We are supportive of measures to bring greater clarity to this area. We feel that the expectations that additional costs would be negligible may not be correct as the cost calculation should not only reflect the initial establishment of the CAT, but also should take account of post-implementation effects, such as the potentially substantial legal fees incurred in disputes arising between the CAT and the administrators. Additional litigation may also likely arise from claims against a CAT for breach of duty, which may include a failure to return client assets in an appropriate or expected timeframe. The cost element of the CAT is therefore another area of the proposal which needs further thought.

Q 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?

We are unsure whether an individual from the CAA (i.e. the FSA) would be best qualified to for appointment as a CAT, given a variety of issues including potential liability. In this context, it would be helpful to have clarification on the potential personal liability of the CAT and CAA (where CATs were to be appointed from the CAA). The issue of how investors could hold a CAA-sourced CAT accountable for breaches of duty in fulfilling CAT functions would need to be carefully considered.

Q 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?

We are supportive of measures to bring greater clarity in this area. However, we are uncertain of the merits of the proposal for a CAA, believing instead that alternative measures such as enhancement of the existing FSA arrangements around the specialist team responsible for the CASS regime may be more constructive. We would support the Client Assets specialist team within the FSA following the Risk Review Teams (“RRT”) model, rather than the UKLA model. Establishing another regulator, while alternative more meritorious measures are available, may give rise to unnecessary duplication and to inefficiency. It is noteworthy that globally the trend is towards regulatory consolidation.

Q 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?

We are supportive of measures to bring greater clarity to this area. However we do not support the proposal for the FSA to be granted powers to sit on the creditor or client assets committees. If the CAA was to be introduced, then we would envisage two key mandates for it: (1) to assume the existing responsibility of the FSA supervisors, in particular, for policy advisory on the CASS rules and risk monitoring in relation to regulated firms while going concerns; and (2) to assume the responsibility for the oversight of administration of a failed firm. We do not support the proposal for the CAA to hold voting rights. It is our view that an objective of an authority should be balanced well in order to bring about the best possible outcome for creditors as a whole. It would be extremely difficult for the CAA acting for client money and assets holders not to be conflicted with the interest of the failed firm's other creditors and shareholders. It also raises the question of how personal liability claims against the CAA could be handled (See our answer to Q57).

Q 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?

We are supportive of moves to bring greater clarity to this area. However we are uncertain of the merits of the proposal for the establishment of a CAA. However, if the CAA were to be introduced, we believe that a CAA regime should apply to all regulated firms with Part IV permission to deal with client money and assets. It is important to ensure a level playing field also for regulators in having regard to statutory objectives such as market confidence and investor protection.

Q 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?

We are supportive of moves to bring greater clarity to this area. However we are uncertain of the merits of the proposal for the establishment of a CAA. We would like further clarification on the assessment why the costs are expected to reduce, while responsibility for supervision and policy advisory stays unchanged. If non-specialised FSA supervisors are able to perform the role of the CAA, we would question why there is a need for another regulator in a form of the CAA. We would reiterate our preference for the specialist team modelled after the RRT teams.

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

As we have stated above, we believe the CAT proposal has some merits but more details of the proposal need to be worked through so that an informed view can be taken. We are not at this stage convinced of the merits of a CAA.

Alternative measures to address the identified issues are available as set out elsewhere in the Consultation Paper and we feel these measures may offer a sensible alternative and certainly should be considered keenly by the Government. We feel these measures are consistent with the existing approaches giving rise to both greater certainty, improved market confidence and lower costs.

Q 63 Throughout this document, the Government is seeking stakeholder input to asses the likely costs of proposals. Preliminary work with the industry indicates regulatory action to address incorrect TSO flagging, 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.

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

We agree that incorrect TSO flagging needs to be addressed. TSO flagging is a particular problem in OTC trades like having to express the venue in the trade report while there is no concept of venue for OTC trades like an "exchange". We believe most firms have in-house records to identify the trade venue but when a report is transmitted from firms, there is no field to receive and allocate information relating to the venue. This is just one of the issues, already identified for action as part of the wider work to improve data quality in trade reporting. We believe that the issues relating to multiple bookings are also very relevant to consider in the same context of data quality.

We are therefore strongly of the view that the issue of TSO flagging is not an issue that can be considered in isolation. Any proposal to be taken forward by the Government in this respect needs to expressly recognise that TSO flagging must be considered in the wider context of trade and transaction reporting issues in relation to which the UK authorities need to take an holistic view of:

- UK specific issues in relation to increased competitive issues; and
- current EU legislation proposals via the European Market Infrastructure Legislation (EMIL)
- the recent CESR Level 3 guidelines on MiFID Transaction Reporting.

Any solution in respect of TSO flagging needs to consider TSO Flagging as part of this wider context and to solve all three of the regulatory environments identified above as well as any other relevant regulatory or market led issues.

Please note that the market is currently taking action to resolve TSO flagging issues and in light of the complexities highlighted above and the current market activity there is no need for regulatory action at this stage; if it becomes apparent that the market driven solution is not addressing the issue of TSO flagging it may be necessary at that stage to consider a regulatory based remedy.

Q 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 for all affected parties, including creditors? What other options should the Government consider?

We broadly support the proposal as set out in paragraph 6.25 of the Consultation Paper; in particular we agree that there should not be a prescribed set of default and trade rules for MTFs but rather the scope of their application should be clear.

We are of the view that the Part 7 protection has so far worked well in regulated markets and, based on this experience, the advantages of extending Part 7 type protection to cover the default rules and trades of MTFs would be to deliver better transparency to affected parties in respect of certainty of an outcome. We would welcome any proposals, designed to ensure a consistent application of a set of default rules across the market/asset class concerned, and an extension of the Part 7 protection to MTFs would be helpful if it is adequately tailored to be suitable for the particular market/asset class. But we would not want a proliferation of different default rules for different trading platforms in the same market.

Q 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?

We 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; please see our response to Question 67 for fuller details. In terms of how the Protocol could be improved, please see our response to Question 67 below.

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

We do not agree that the AFME Protocol, or an equivalent, should be placed on a regulatory footing. We are strongly of the view that the market driven approach is adequate and ensures that the Protocol meets market needs in the most effective way.

The AFME protocol is a private contract among its adherents and the use of this tool is primarily a commercial matter rather than a regulatory matter. In particular, we are of the view that the market understands the issues that require addressing and there does not appear to be any requirement for regulatory intervention to be imposed across market driven solutions. To this end, we believe that the AFME Protocol is a step in right direction. The UK financial services industry is committed to pursue market-led solutions and there is no requirement for the Government to resort, at this stage, to regulatory or legislative measures.

It is our view that placing the Protocol on regulatory footing may be premature and possibly counterproductive before efforts to implement market-led solutions exhaust themselves. As a matter of process, we believe the focus should be on obtaining agreement from the major sell-side industry participants first, with a view to extending it to the buy-side in due course.

Q 68 Do you have views on the valuation mechanisms 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?

We support the consistent industry-wide use of a net valuation mechanism to be truly effective. The net valuation mechanism has been "tried and tested" in other markets, and is supported by potential adherents.

Q 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 insolvency of a counterparty, or may in the future? If so, please specify.

To identify other relevant asset classes, it will be essential to engage relevant platforms and clearing systems for each asset class to analyse how their mechanisms would function in a scenario of a member's/a market participant's default. We are of the view that, the main issue is how default terms are in practice exercised in the trading and settlement process, although a lack of /or unclear default terms between counterparties also need to be addressed.

Again, we support a market led solution to identifying any relevant asset classes and addressing any specific issues relating to such asset classes.

Q 70 What would be the advantages and disadvantages of extending the protections provided for 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 costs and benefits of intervention in this area, and its distributional impact?

The market currently provides central clearing on commercial terms. Market participants that do not have the benefit of central clearing are in that position because they chose not to enter into a commercial arrangement with a CCP. We are strongly of the view that if market participants have concerns about the clearing of trades they have the ability to sign up to a CCP that will provide access to the existing protections provided by Part 7 CA 1989. There does not appear to be an over-riding argument for a regulatory solution to these concerns establishing market products already provide an adequate commercial and market driven solution.

In particular we do not support Government intervention in this area and believe that such action is unnecessary and would result in market participants that did not wish to access and pay for clearing services being required to bear the cost of the regulatory solution.

We believe that market-led initiatives should be given time to develop wherever possible. Regulatory intervention would be needed if market-led initiatives were exhausted or faced with obstacles which the private sector alone cannot remove. This is because hard-wired rules could not often meet market participants' needs fully due to the inflexible nature of regulation.

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

We welcome and support efficiency and transparency for effective risk management. However, the focus of initiatives should be on an outcome/result to achieve the objectives, rather than on the methodology.

To this end, please see our response to Q70. Please note in respect of the concerns highlighted in paragraph 6.63 of the Consultation Paper, market products already exist to provide the services identified to market participants. Paragraph 6.63 of the Consultation Paper makes it clear that appropriate market products are available and access to such products is an issue of commercial terms.

We would further observe that, depending on the nature and operational practicality of the markets, current practices differ substantially from market to market. For example, while margining client business on a net basis between clearing member and central counterparty is the norm in the futures and options market, gross margining is a standard in relation to OTC cleared CDS business. We, therefore, think that market-led initiatives, which allow a tailored approach to meet the participants' needs, should continue to be encouraged.

Q 72 Cost Benefit Analysis

For the reasons set out in our response to Question 73 below, we reiterate our view that, in principle, we believe that market-led initiatives should be given time to develop wherever possible. Regulatory intervention would be needed if market-led initiatives were exhausted or faced with obstacles which the private sector alone cannot remove.

In respect of the specific cost-benefit issues, we note that the Government's approach in respect of cost-benefit analysis takes account of the implementation cost but it does not appear to have considered possible implications of such rules post-implementation. We think that the cost could be higher when possible negative implications post-implementation are included in the calculation.

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

We are strongly of the view that the appropriate response for a market demand for such facilities should be a market driven solution. There is no requirement for such an obligation to be imposed on the market when CCPs will respond to market demand or lose business to other CCPs.

We reiterate our view that, in principle, we believe that market-led initiatives should be given time to develop wherever possible. Regulatory intervention would be needed if market-led initiatives were exhausted or faced with obstacles, which the private sector alone cannot remove. This is because hard-wired rules will often not meet market participants' needs fully due to the inflexible nature of regulation. We have reservations about mandating the regime, while we are fully supportive of the availability of choices for segregated accounts both at the CCP-level and the level of the firm.

We would also question if there is any need for mandating a regime in the UK where CCPs' current practice already offers segregated accounts. As we have referenced earlier, we believe clients should be informed about the protections available to them and then make an informed choice on that basis as not all clients operate with the same risk or cost appetite.

Q 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? (B) What would be the advantages and disadvantages?

As we referenced in our response to Question 73, we believe clients should be informed about the protections available to them and then make an informed choice on that basis as not all clients operate with the same risk/cost appetite.

Again, the appropriate response for a market demand for such facilities should be a market-driven solution. There is no requirement for such an obligation to be imposed on the market when clearing member investment firms will respond to market demand or lose business to other clearing member investment firms.

In particular, we would note that an imposed requirement for account types will not deliver such an effective solution as allowing client driven demands to drive the products available to clients. If clearing member investment firms are obliged to establish products for which there is no clear demand it may result in an unnecessary additional cost to the market for accessing clearing. However, if there is a genuine demand in the market for such arrangements clearing member investment firms will respond or risk losing business to other clearing member investment firms.

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

We welcome cross-border initiatives to coordinate default arrangements, as transparency and clarity on this matter are important particularly for firms with international operations. We believe that there should be a particular focus on interconnectivity (or risk contagion) of cross-border clearing. Interoperability is needed under normal circumstances for business to effectively function, but it is necessary to place appropriate safeguards to control risk contagion arising from a member's default.

We also believe it would be helpful for CCPs to provide more information about their own structure, rather than have firms provide that information in effect on their behalf to clients.

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

Broadly EUI's approach appears to be supportive of the requirements of the market.

However we would urge HM Treasury and the Government actively to participate to the fullest extent possible in all relevant EU policy and regulatory initiatives to ensure:

- The Government's proposals in this Consultation Paper do not directly or indirectly conflict with any such proposals; and
- The competitive position of the UK financial services industry is not adversely affected by any such proposals or initiatives.

Q 77 Have the consequences of EUI's proposal to increase certainty of settlement been identified correctly and do the benefits for the market as a whole of the proposed revised approach outweigh these consequences?

We believe that the consequences of EUI's proposal to increase certainty of settlement have been identified correctly and that the benefits for the market as a whole of the proposed revised approach outweigh the potentially adverse consequences. We expect to remain in close touch with EUI and the authorities as these proposals develop.

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

We do not believe that Government action is currently required to address contractual terms. The market is currently discussing the required nature of contractual terms and we will revert once these discussions have progressed.

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

We do not believe that regulation or legislation is required. Please see our response to Q78.

Managing Complex creditor positions – Chapter 7

We have had the benefit of reviewing the ISDA response, which we support.

Working towards cross - border resolution – Chapter 8

This chapter touches briefly on a number of important issued. We urge the authorities to remain in close touch with stakeholders as these initiatives develop.

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Alternative Investment Management Association

Investment Banking Resolution
HM Treasury
1 Horse Guards Road
London
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By email to: alex.white@hm-treasury.gov.uk

16 March 2010

Dear Sir / Madam,

AIMA's response to HM Treasury's consultation paper 'Establishing effective resolution arrangements for investment banks'

AIMA[1] is pleased to have the opportunity to respond to HM Treasury's paper 'Establishing effective resolution arrangements for investment banks' (the Consultation), a further stage in this consultation.

Our responses to the Consultation's specific questions are set out at Appendix 1 here and we also make some general observations on the Consultation below. Please note that, as a body representing the hedge fund industry, we do not have views on all of the specific questions.

AIMA's membership covers both the "buy" and "sell" side of investment banking transactions (e.g. investment managers and prime brokers) and differing interests and views sometimes exist across that spectrum. Our response may, therefore, at times reflect a range of views, although we have particularly sought to reflect the buy-side's views in our responses.

General observations

AIMA welcomes the Government's commitment to financial stability and to protecting and enhancing the UK's reputation as one of the world's key centres for conducting investment banking business, with the intention of implementing a balanced and proportionate response to the issues highlighted by the failure of Lehman Brothers.

AIMA supports the Government's commitment to implement measures that "place the UK on a strong footing to deal with any future failure of an investment firm" and we welcome efforts to increase clarity and certainty for market participants in relation to issues that arise upon an investment bank failure, with the aim of achieving better outcomes for key groups affected by such a failure, namely:

- speedier return of client money and assets;
- addressing counterparty exposures to the firm; and
- ensuring creditors are sufficiently protected.

We firmly believe that the measures proposed should be carefully targeted to ensure that the aim of effectively dealing with resolution arrangements for investment banks is directed to and affects those firms which, upon failure, would cause real systemic problems for the market.

We are concerned to ensure that the definitions of 'investment firm' or 'investment bank' should be limited to only those systemically relevant investment banks which the proposals are designed to capture.

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[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,100 corporate bodies in over 40 countries, with approximately 30% of our members based in the UK and, of them, almost 200 are hedge fund management firms (another 55 are fund of funds managers).

The term 'investment firm' as defined in the Consultation glossary, which is based upon the definition in MiFID, is far too wide, and would include a range of firms that do not pose a risk to the financial system and for which the proposals simply do not make sense. In our submission, provisions designed to protect client assets and monies are not appropriate for "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis", which do not themselves necessarily hold client assets and monies.

AIMA supports the Government's commitment to apply proposals proportionately, to avoid placing undue burden unnecessarily and perhaps unintentionally on smaller firms.

AIMA is keen that increased clarity and certainty for market participants does not come at the expense of flexibility and choice, although we recognise that they will often only come at a cost, both for investment banks and their clients.

AIMA is concerned that market participants should have the clearest understanding and awareness of the process that would apply on insolvency, and of the consequences for the contractual arrangements they enter into and the legal and regulatory framework within which they operate.

Client assets and monies

Reporting and other operational transparency aspects are key issues for many of our members and we support finding an appropriate balance between clarity of improved reporting and the cost and burden that may arise from excessive volumes of data.

The Lehman failure heightened concerns as to proper allocation of client assets and the prompt return of those assets on the investment bank's failure. AIMA's members support improved operational arrangements from industry as well as legal and regulatory frameworks that encourage open and transparent arrangements for holding client assets. To effect return of those assets upon failure, AIMA believes that giving administrators administration objectives that promote prompt return of client assets, with assistance from an FSA Client Asset Agency, is desirable, instead of promotion of the use of specific Client Asset Trustees, which are likely to lead to conflicts and duplication of efforts.

Additional points we would make are:

- Although setting a 'bar date' for client claims might appear to aid the return of client assets on insolvency (and the absence of such a limitation was certainly a difficulty in the Lehman administration), we note that this proposal may not be effectively reconciled with provisions protecting clients' rights to property. We suggest that much more detail should be provided on the shortcomings of current limitation periods, before considering any proposal for change; current limitations for claims should be sufficient to protect an individual's proprietary (or contractual) claims without, at the same time, being unduly onerous on firms.

- The ultimate aim of maximum client asset protection might give rise to proposals that frustrate the efficient resolution of an insolvent service provider. For example, the benefits of treating client assets as trust estate and treating 'house accounts' as fungible pools of assets available to the general estate is an approach which has the best chance of minimising delays in the return of assets in insolvency. To take steps to interfere with those two distinct pools of assets by creating another plane of rights, which transcend the limitations of the equitable remedy of tracing, may well lead to greater administrative workload and further delay in distributions. In short, prescribing contractual provisions which are predicated on the hope of a certain outcome does not overcome the practical implications of poor record-keeping.

We are, of course, keenly interested in the FSA's forthcoming consultation on client assets and money, with proposed regulations.

Conclusion

We welcome the Government working with market participants to develop effective resolution arrangements for investment banks, and its continued consultation with all participants on specific proposals now being developed. AIMA looks forward to continuing to contribute its views as HM Treasury takes forward its work to publish detailed proposals.

Yours faithfully,

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APPENDIX

AIMA'S RESPONSE TO HM TREASURY'S CONSULTATION PAPER – "ESTABLISHING RESOLUTION ARRANGEMENTS FOR INVESTMENT BANKS"

CHAPTER 1 - Introduction	
Question 1	**Do you have any comments on the proposed definitions of investment firm for the purposes of this work?**
Comments	The purpose of HMT's proposals is to reduce the impact of a major investment firm failure on financial stability. Therefore, the scope of the proposals which will be set out as a first point in the definition of 'investment firm' or 'investment bank' should be limited to only those systemically relevant investment banks which the proposals are designed to capture. The term 'investment firm' as defined in MiFID is far too wide, and will have the consequences of capturing a range of firms that do not pose a risk to the financial system and for which the proposals simply do not make sense – i.e. provisions on protection of client assets and monies are not appropriate for "institutions conducting investment activities on a regular basis" which do not themselves hold client assets and monies. The Government's commitment (paragraph 1.24) to ensuring that proposals are applied proportionately and are designed to avoid placing undue burden on smaller firms is encouraging. The proposals in relation to Chapter 2 as scoped out in paragraph 1.25 seem to use an appropriate definition of 'investment bank' and we would encourage the Government to consider and adopt appropriate definitions for each of the proposals. Although there is a clear need for the Government to implement some of the proposals, it should recognise that many of the provisions are onerous in terms of costs of implementation and maintenance and ongoing commitment of time. We would encourage provisions that are proportionate (in terms of such requirements) to the size of a firm, its systemic relevance, range of activities and amount of trades enacted / client assets and monies held. For the purposes of the special administration regime, the benefits of invoking the regime may well depend on the complexity of the insolvent business in question. The impact of the regime will largely affect administrators, creditors, counterparties and clients, rather than the firm itself (as it will generally only apply post-insolvency). Therefore, there is no need to further refine the current definition, but discretion could be given to the appropriate authorities to declare whether the regime should apply in a particular case (as contemplated in paragraph 2.48 et seq). Non-binding guidance on how the authorities are likely to apply the definition would be helpful. We understand (per paragraph 2.44) that the principle of limiting directors' liability in relation to action taken to minimise the losses of creditors under a 'living will' should be linked to whether the firm in question is subject to living wills legislation implemented under the Financial Services Bill. This seems sensible, subject to comments on the need to implement certain of the proposals at all.

	In relation to proposals that could have a cost/systems impact on firms pre-insolvency, the scope should be defined precisely *ab initio*. We believe that a *de minimis* size test should apply to the definition, to avoid disproportionately burdening smaller firms, as recognised by HMT in paragraph 1.24. (This could, for example, be linked to the test that is applied to firms subject to the remuneration code (SYSC 19.1)). However, the Financial Services Bill provisions in relation to living wills appear likely to apply to deposit-taking institutions (which may not be investment firms) without reference to size tests. Firms wanting to demonstrate to clients and counterparties their ability to achieve an orderly resolution could opt into recovery and resolution plan (RRP) rules and those firms not opting in could be required to disclose the fact.
CHAPTER 2 – Enabling an Orderly Resolution	
Question 2	**Do you agree with the Government's proposals for special administration objectives and associated policy measures? Are there any supporting levers not considered in this document that would be critical for the effective functioning of the special objectives?**
Comments	Broadly, yes. The client assets trustee (CAT) proposals in Chapter 5 are important but these powers/duties should be given to the administrator under the special administration objectives (SAOs), rather than to a separate CAT. One issue that will need to be addressed, to enable the effective functioning of the SAOs and the CAT's duties, is that of encumbered assets (in particular, affiliate liens). Without a quick method of ascertaining what affiliate liens are in place over trust assets, all the other return of trust assets mechanisms will be frustrated. Options for dealing with affiliate liens would include: (a) disallowing such liens for the purposes of the SAOs/CAT distribution mechanics to the extent that such liens are not recorded in the records kept by the insolvent firm (pursuant to the Chapter 4 proposals) and not included in the information reported to the trust clients (as per the Chapter 4 proposals); or (b) allowing the administrator/CAT to impose an affiliate bar date (along the lines of the proposed bar date for trust asset claimants under paragraph 4.77 ff) and in each case allow the administrators to distribute trust assets (without further liability) on this basis. One difficulty with this is the international element (i.e., the administrators may still face potential liability to an affiliate under the insolvency laws of the jurisdiction of that affiliate – e.g., if the distribution were to be construed as a breach of a US Chapter 11 stay). The premise that financial services insolvencies should be singled out for special treatment (i.e., the SAOs) should be justified in relation to each proposed amendment, as many of the objectives that are being espoused (e.g., limitation of administrator liability; speeding up of process) could be said to be equally desirable in any complex insolvency, regardless of whether the complexity is due to matters pertaining to the financial markets. Indeed,

	the existing law already attempts to strike a sensible balance between the competing principles. Therefore, the effectiveness of any amendment to that law is likely to depend on very subtle amendments to existing legislative drafting, rather than wholesale changes of philosophy. It is difficult, therefore, to agree in principle that speeding up the process ought to be a priority for new legislation, given that it is an existing priority, which needs to be balanced against the need not to make bad decisions. Similarly, the principle that administrators and directors ought to be able to take bold action without fear of liability has its obvious disadvantages as well as advantages. It may be that the best method of achieving the advantageous outcomes is not, in fact, new insolvency legislation, but rather an amendment to existing administrative procedure and allocation of resources - for example, putting in place a reserve to fund additional expert resource for courts and regulators, to enable them to be more responsive to requests for directions from administrators and directors at times when insolvencies are more likely. Two of the key reasons that have been proposed as justification for different treatment of financial services insolvencies are: (1) the continuing operation of the investment markets and (2) the precedence of customer claims over claims from other creditors of the failed firm. Whilst these are both laudable objectives, we feel that more clarity is required as to how this should be achieved in practice, in order to determine whether an amendment to insolvency law is likely to achieve the desired result. We set out below an analysis of practical situations. Based on those examples, we do not understand how HMT's proposals would change the outcomes that would be likely to arise under the existing law. In relation to (1) above, it is already an important role of administrators to close out and, so far as possible, settle trades than have been entered into by the firm. However, administrators are not and should not be able to 'cherry-pick' which trades they wish to settle. Where the counterparties to a trade constitute creditors of the firm, it is difficult to see how their claims can be settled before their entitlement has been determined along with the firm's other creditors. The precise wording of proposed legislation may shed light on this, but a broad statement of intent that the continued operation of the investment markets should be an objective of administrators may prove rather hollow if practical examples are not given as to what steps administrators should take and how this differs from their existing obligations. In relation to (2) above, the consultation paper talks at length about the inability of the administrator to prioritise the claims of clients who are owed client money and client assets over the claims of the general creditor pool. We assume that HMT is referring only to assets which have not been segregated from the firm's own assets as, generally speaking, client money and assets should be segregated - enabling administrators to be able to pay clients the proceeds of the client accounts without considering the position of creditors. The exceptions to this general rule arise principally where client assets are either not in fact segregated as they should have been, or where rights to re-hypothecation have been exercised. In relation to a client whose assets have not been segregated as they should, there is a presumption under existing trust law that where a trustee holds trust property in an account where it is co-mingled with his own money, any disposals will be taken to have been made from the trustee's own property before deductions are made from trust property. If this analysis applies, the client would have a superior claim to that of creditors by virtue of being a

	trust beneficiary, rather than being a creditor. Where rights to re-hypothecation have been granted, the owner of the assets assumes greater risk by granting the right and they may merely rank as a creditor of the firm. In such circumstances, the considerations applying to trading counterparties applies (see analysis of (1) above).
Question 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?**
Comments	HMT has correctly identified the balance between encouraging decisive action and deterring misfeasance by administrators. The desirability of amendments to the Insolvency Act will depend upon nuances of drafting. We are not convinced that amendment will necessarily alter administrator behaviour, given that current legislation already protects administrators, but agree that any amendments should be limited. The issues addressed in Q5 will have more impact on administrator behaviour and speed of return of assets.
Question 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?**
Comments	We are not sure what this adds to the limitation of liability relating to administrators' actions in pursuant of the SAOs (above). We are not aware of administrators having significantly less liability than directors, except for some specific rules relating to courts being able to exonerate directors. It is not clear why investment firm insolvencies should be different to other insolvencies for the purposes of such limitation of liability.
Question 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?**
Comments	We agree. We believe the most important factor is ensuring that the court has the ability to deal with cases both quickly and expertly, and that the clarification around liability would remove one more barrier to speedy return of assets. The costs associated with funding extra court resource should be justified in cases which the FSA determines are sufficiently important to merit invoking the special administration process (see under Question 1). The introduction of such a process could easily lead to administrators effectively abdicating responsibility for decision-making and applying to courts to vindicate trivial decisions. Under normal circumstances, this could have the effect of slowing the resolution process down and it is therefore critical that the court be particularly responsive. There would also still need to be sufficient notice to stakeholders and the ability for creditors to be heard by the court prior to the granting of the approval.
Question 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?**
Comments	We query whether fears of substantive disruption by creditor action are well founded. In the LBIE administration, the court has shown itself to be highly

	unsympathetic to creditor action and therefore there has been very little. We are not sure whether further modification of administrator liability would actually have any impact on the amount of creditor action. We cannot think of any further modifications.
Question 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 financial stability? What specific modifications could the Government consider applying?**
Comments	This would be necessary if resolution plans are to be implemented as contemplated (i.e., to delay the entry into insolvency proceedings). However we do not think that it is likely to be possible to achieve this result in practice and, if not, the point would become irrelevant.
Question 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 described in Box 2A?**
Comments	We agree – see comments on Questions 1 and 5. We do query why the two could not be run concurrently, however.
Question 9	**Is there a case for considering 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?**
Comments	We agree that the costs of funding failing firms to close out their positions should not be borne by the investment firm community. We understand that the main difficulties in securing third party financing for failed firms is predominantly commercial.
Question 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.**
Comments	We understand that the proposal is not to provide new sources of intra-day support. It appears likely that costs would be fairly low, but this does of course depend on precisely how the regime is implemented by the Government.
Question 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.
Comments	We agree that a single source of all relevant information should be available via all of the websites mentioned. One body should have primary responsibility for maintaining the content.
Question 12	**The Government considers the costs to market participants of a resource centre providing best practice guidance to administrators, and plans for coordinated 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.**
Comments	We believe the authority/ies providing the resource will be best placed to consider costs.
Question 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?**
Comments	This sounds attractive in principle. The difficulty may be establishing whether such opt-in would be effective under foreign laws. The primary purpose of opting in appears to be to provide confidence to clients and counterparties in the event of the firm's failure, but if firms were able to opt in when there were complex issues of international law surrounding applicability of UK law, then it could turn out that any confidence engendered by the opt-in was misplaced.
Question 14	**Are there any other specific issues in relation to cross-border investment firms, not considered here or in Chapter 8, that need to be addressed?**
Comments	None in relation to Chapter 2.
Question 15	**The Government welcomes views on the extent to which the package of measures proposed in Chapters 2 and 3 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?**
Comments	Our responses to individual questions cover the detail of our position in relation to the proposals. In relation to Chapter 2, our view is that the following steps are most welcome: • enhanced expert resource within courts to assist administrators making quicker decisions in relation to large and complex cases; • providing a resource centre to assist administrators dealing with complex investment firms; and • providing information to the markets on important insolvencies through a comprehensive source.
CHAPTER 3 – Requiring firms to manage for failure	

Question 16	**Do you have views on the coverage or detail of the BRO's responsibilities as outlined here? Are these consistent or compatible with existing templates for the corporate governance structure of firms?**
Comments	We agree with the proposals, except that the BRO should not be responsible for ensuring the board implements his recommendations. Also, the BRO should be prepared to assist administrators in the manner described, but should not have the power to take on functions, as sole power would rest with the administrator.
Question 17	**Do you agree with the basic policy of establishing a role for business resolution officers 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?**
Comments	We broadly agree with the proposals.
Question 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?**
Comments	We agree with the proposals to appoint an officer to be responsible for overseeing resolution arrangements, subject to our comments about RRPs and business information packs (BIPs). One of the key responsibilities of the BRO is to be available post-insolvency, even if it would be possible for them to give notice and take alternative employment. For this reason, making the role subject to the approved persons regime gives the FSA a tool for introducing consequences for sub-standard conduct.
Question 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.**
Comments	Once the resolution arrangements have been established, we would hope that it would not be necessary for a COO of a company that is well capitalised to devote as much as 10% of their time to maintaining those arrangements, as this largely equates to maintaining BIPs. BIPs should largely be attempting to map where information is held rather than actually providing the information.
Question 20	**Do you agree that investment firm resolution plans can consist of internal actions followed by market-facing actions as proposed above?**
Comments	We find the reference to Phase 1 as the firm's internal resolution actions confusing, as these appear to be recovery plan steps. Phase II, the "pre-insolvency corridor", however, appears to arrive at a point when the firm may well already be insolvent and, therefore, does appear to sit logically within the resolution component. It is not clear to us that it will

	be possible to create such a corridor that lasts for a standard length of time, as discussed below under Question 21.
Question 21	**What are the obstacles to implementing investment firm resolution plans as suggested in this paper? What policies could the Government consider to address these, if any?**
Comments	The major obstacle is that the speed of market reaction to a potential insolvency is likely to make it impossible for the firm to create a pre-insolvency corridor of any meaningful length of time. The costs to industry of preparing and implementing plans pretending to achieve this end do not appear justified in these circumstances.
Question 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 outlined here, do you agree with the suggested costs for the prime brokerage business?**
Comments	We query whether this figure relates to both recovery and resolution plans. If the figure merely relates to resolution plans, then we do not feel it is justified for the reasons set out in response to question 21. In relation to recovery plans, the Government should seek to ensure that these costs are greatly reduced for non-complex firms. Certain investment firms (using the current definition) may have regulatory capital as low as €125,000. This is one of the key areas where it will be necessary to have a defined scope of the firms caught, including a size threshold. The Government should also seek to reduce the cost to industry generally as the benefit in investment firms following pre-determined plans to manage financial turmoil may be insignificant in comparison with the cost of the entire industry preparing and maintaining those plans. We would be interested to know of the Government's cost valuation of the benefits. The

	pilot exercise with major banks should be used to inform these aims and attempt to focus on practical steps, such as division of responsibilities on insolvency rather than speculation on possible reactions to numerous scenarios.
Question 23	**What resources do you expect the entire investment banking business of the firm to spend on resolution plan implementation? Costs would include those related to: (a) designing and setting up resolution plans in collaboration with the FSA; (b) the ongoing audit and update of resolution plans and their inclusion in the firm's corporate governance activities; and (c) the additional resources required to implement resolution plans in a distress situation, if any.**
Comments	AIMA has no comment.
Question 24	**Do you agree that business information packs will be useful to administrators and will fulfil the Government's objectives for a managed wind-down of investment firms?**
Comments	Yes, although the cost saving it will achieve needs to be considered.
Question 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.** **As in the case of resolution plans, there may be ongoing benefits to the investment banking business from having in place continually updated BIPs, but these are not included here.** **Based on the proposals for BIPs outlined here, do you agree with the suggested costs for the prime brokerage business?**
Comments	The Government should seek to ensure that these costs be greatly reduced for non-complex firms. Certain investment firms (using the current definition) may have regulatory capital as low as €125,000. This is one of the key areas where it will be necessary to have a defined scope of the firms caught, including a size threshold. The Government should also seek to reduce the cost to industry generally as the benefit in administrators having better information may be insignificant when compared with the cost of the entire industry continuously maintaining BIPs. We would be interested to know of the Government's cost valuation of the benefits.

Question 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.**
Comments	AIMA has no comment.
Question 27	**The Government would welcome views on what incentives and disincentives are likely to be effective and whether there are any concerns with the ones suggested above.**
Comments	We understand that administrators already use tools like bonuses in order to retain staff and should consider their use as a matter of course. However it would not be possible to require Administrators to pay certain levels of remuneration and if this cannot be reflected in staff contracts, it will be difficult to oblige staff to remain with the firm as a matter of contract. For BROs and possibly a limited number of core key staff, the approved persons regime can be used by the FSA to disincentivise them from seeking alternative employment whilst their assistance with the insolvency is required, but this needs to balanced against the fairness (e.g. of remuneration levels) on which the staff can be retained.
Question 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?**
Comments	The concept of key staff should only apply to essential staff rather than persons whom an administrator may find useful to retain. If the concept were defined too broadly, it would be difficult to define precisely which staff were "key staff" on an individual by individual basis at any given moment in a solvent firm's existence. The notion behind key staff should be that they are made aware when they are engaged in the role that their assistance will be required post-insolvency and their employment contract should reflect that and their departure should lead to sanction (for being improper) in those circumstances. It would not be fair to attempt to contractually oblige a large number of staff to remain post-insolvency, as there would be a high possibility that the administrator would not choose to retain them in any event. Non-key staff roles may have several individuals capable of performing them. It would be desirable to retain the flexibility Administrators currently have to offer such roles in the insolvent firm to one of a number of candidates based on facts on the ground: willingness to remain, aptitude, price etc.
Question 29	**What do you consider would be an appropriate measure to ensure that the fees that suppliers charge post-insolvency are not inordinately high? Do you believe the Government can take specific action in this regard?**
Comments	Provided payment is made to service providers in advance, it should be possible to require firms to insist on contractual terms, ensuring that a service provider's fees are not raised beyond normal increases in the fees that would have arisen regardless of the insolvency. Once the notice period

	under the service level agreement expires, we cannot think of a workable mechanism for the administrator to insist on fee levels under a new contract. One possibility would be to agree longer notice periods for essential services, where fee levels and a lack of alternative providers are likely to be an issue. This is action that the Government could ask firms to consider taking when entering into contracts, but we cannot see how it could affect the post-insolvency outcome if a firm had not previously taken such steps.
Question 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 renegotiating 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. The cost implications of associated policy measures such as an operational reserve for the payment of staff and essential services, the BIPs and BRO are examined in the relevant policy sections.** **Do you agree with the cost estimates suggested above, for contractual provisions for key staff and suppliers? What are your views on the incremental costs of: (i) renegotiating 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?**
Comments	We believe the scope for reviewing all service level contracts and employment contracts, attempting to re-negotiate them and devising new precedent contracts is likely to be very significant and in some cases, may not be possible due to weak bargaining power. On-shoring essential IT infrastructure will also be extremely expensive for certain businesses. We have not been able to conduct cost surveys, but the figures are likely to vary significantly and we would be sceptical about the reliance that can be placed on the figures provided by stakeholders.
Question 31	**What alternative policy tools 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?**
Comments	The negotiation position of larger firms is likely to be much greater than smaller firms, so the scope of firms caught must be considered more closely. Generous transitional provisions should be introduced to reflect the fact that firms may not be able to re-negotiate contracts as envisaged. Firms should also be given some flexibility in their contractual negotiations rather than being forced to agree specific provisions or not enter into contractual relations at all. The requirement for firms in administration to continue to provide services could be difficult to enforce and may in fact be difficult for an insolvent firm to comply with, even if it were obliged to.

	As we believe the costs are likely to be high, this will be particularly unattractive for smaller firms caught by the proposals and those with offshore IT systems.
Question 32	**What are your views on legislative changes requiring administrators to use the operational reserve only for operational expenses?**
Comments	Identifying the amount of the operational reserve may be difficult where a firm holds liquid assets in excess of the reserve requirement. If, in fact, the administrator believes that better use can be made of the cash available to it, then it would appear overly prescriptive to insist that the entire reserve requirement amount is only used for operational expenses. The liquid resources available to the administrator should all be treated in the same manner. There may be a presumption that administrators would seek alternative funding to settle open positions however.
Question 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 the suggested cost estimates above? 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?**
Comments	AIMA has no comment, but notes that this is a substantial amount.
Question 34	**Do you have any views about the operational reserve proposed in Chapter 3?**
Comments	The operational reserve should be part of the firm's liquidity resources requirement rather than being aggregated with other liquidity requirements.
CHAPTER 4 – Reconciling and returning client property	
Question 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?**
Comments	We would encourage clarity as to how the shortfall in client asset omnibus

	accounts is treated on insolvency. However, it may be prudent for the Government to await the outcome of the current Lehman (LBIE) insolvency appeals case on client assets before proceeding with these changes. It would be helpful to give legislative effect to the views of the Financial Markets Law Committee (the FMLC) in this area, as set out in their paper "Property interests in investment securities" as, notwithstanding the arguments against making participants in an omnibus pool share in a shortfall pro rata to their entitlement, it is the best way of ensuring clarity and, therefore, should result in a speedy return of assets on an insolvency. Briggs J has already opined on when clients' entitlement to their assets should be calculated and it may be helpful also to formalise this in legislation.
Question 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?**
Comments	We disagree that the proposed 'warnings' on the implications of rehypothecation and the use of omnibus accounts are necessary in contractual agreements between professional and sophisticated market counterparties. However, the greater use of contractual terms setting out the relationship between the parties in these sorts of matters may be useful, but we believe that this is a matter best addressed by the parties themselves and not through legislation. The administrative burden and cost of designed client custodian accounts is likely to be off-putting for clients. Should clients require such a service, it is expected that the industry will be able to provide a solution at an appropriate market rate, without the need to require custodians to offer such accounts. Mandating warnings will be ineffective for the most part and will not be useful. Experience shows that consumers rarely (if ever) read them (e.g. certain statements on futures contracts) and sophisticated clients are attuned to the implications of rehypothecation and omnibus accounts from a legal perspective. We find it hard to see how that can be implemented effectively. This is an area where the FSA could promote awareness of the implications rather than mandate more disclosure and risk warnings. It would certainly allow clients to mitigate insolvency risk if they were entitled to insist on designated accounts at the custodian level. However, it would dramatically increase the costs of business if assets were to be held this way and it should be made clear to clients that the efficiencies to be achieved by netting would not be available. We also believe that requiring firms to offer designated named accounts is not an appropriate measure. This would give rise to increased costs and administrative burdens, which will be passed onto clients.
Question 37	**Do you agree with the Government's aim to encourage clarity in contractual agreements? If so, how is this best achieved?**
Comments	Again, sophisticated market participants should be able to include provisions in contractual agreements which they feel are necessary to provide them with sufficient clarity, without the need for a legislative solution.

	It is, however, sensible to encourage clarity in contractual agreements. Perhaps the best way to achieve this is to produce a detailed industry consultation paper, to encourage improved market practice. It may be that a "sound practices" educative note from an industry body such as AIMA would serve the purpose better, and such a note could be updated periodically to keep in line with latest market developments.
Question 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.**
Comments	This is a somewhat conservative estimate of the costs. Typically, a legal review of these matters will involve a review of existing documentation and careful deliberation of what changes will be required. This may also involve a consideration of the provider's operational set up. A more realistic estimate would be £20,000.
Question 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?**
Comments	One of the main purposes of providing prime brokerage clients with reporting of the type under consideration is to enable those clients to determine (1) the extent to which the prime broker is adhering to contractually agreed limits on rehypothecation etc., and (2) arguably much more importantly, the extent to which their holdings with the prime broker are exposed to the creditworthiness of the prime broker, and the extent to which those clients would have a proprietary claim. In view of the terms of this second stage in the Government's consultation, it seems unlikely that any reporting that is mandated would assist clients in respect of the second of these considerations. This is because there appears to be no aim either (1) to establish a pre-insolvency trust in relation to client assets that is comparable with the statutory trust applicable to client money, or, although this would not provide as much certainty, (2), to require that prime brokerage contracts be express as to the circumstances under which assets held by the prime broker are held as trustee and the circumstances under which they are held as debtor. The ability to distinguish between these two categories enables clients facing a prime broker that would be subject to the UK insolvency regime upon default to manage their respective credit exposures by limiting the leverage they employ and the rehypothecation they permit. Such management is not possible in US prime brokerage under the Customer Protection Rule for broker-dealer accounts, and it would be of considerable benefit to London as a financial centre, as well as providing more appropriate outcomes for different types of client, were the Government to take measures to support the possibility of such counterparty risk management in the UK insolvency

	regime. Nevertheless, if the Government decides to proceed with its increased reporting proposals, without also providing for a pre-insolvency trust for client assets or requiring specific and express contractual provisions in prime brokerage contracts, we would urge that the requirements of firms should be proportionate in terms of costs, practicalities and taking into account the potentially limited benefits. Measures to assist administrators in easily identifying client property in the event of a firm's insolvency would clearly be of benefit but there will probably be considerable challenges in implementing the IT solutions to meet reporting requirements and so this is likely to take time to implement. In terms of timing and content, the Government should consider the speed at which information in a moving market becomes outdated - a balance should be struck between the goal of ensuring clarity and certainty, on the one hand, and production of excessive volumes of unhelpful data, on the other.
Question 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?**
Comments	Yes, there should be a formal requirement for proper record-keeping and reporting (with appropriate penalties for failure). Increased record-keeping would be beneficial for clients on the insolvency of investment banks and recording of settlement date and trade date information should be mandated. It should not cause undue difficulty for firms to enhance record-keeping as proposed by the Government. The main delays on return of assets in insolvency tend not to result from legal uncertainty but rather from a lack of sufficiently clear and comprehensive records. The proposals by the Government in this regard are to be welcomed. It would be vital to ensure that firms actually comply with the requirements: the law and regulations are only the first half of the equation – the second is what happens in practice (i.e. whether firms comply with the rules).
Question 41	**Do you agree with the Government's support for increased audited disclosures by firms around client money and assets? Should Government require firms to make available audited client money and assets reports to clients?**
Comments	We agree that increased audited disclosures around client money and assets should be available. We await the FSA's future detailed proposals on increasing audited disclosures, as these must ensure that they are providing regulators with information which they require. There is no reason why firms should not be required to make available audited client money and asset reports to clients on request. We understand that LBIE was 'given a clean bill of health' when its client money practices were audited, yet they were shown to have been far from

	perfect. We query whether showing the reports to clients would serve any practical use, other than as a means of passing the burden of checking whether firms are complying with the rules onto clients.
Question 42	**Should the Authorities clarify the scope of FSA CF-29 and centralise CASS oversight under one individual?**
Comments	It would seem sensible to give client asset and money oversight to one individual, who is fully qualified and capable of performing this duty. We await the FSA's forthcoming consultation on controlled functions and the CASS sourcebook for further details. Firms are already used to allocating compliance with oversight of client money rules. The CF29 function could be expanded to client assets as well.
Question 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.**
Comments	We do not dispute these costs. We would expect smaller firms may face lower costs.
Question 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?**
Comments	We would encourage the use of bankruptcy-remote vehicles and would encourage Government measures that further the ability of clients and firms to have clarity on the position on insolvency, where there is need for it. However, due to the different structures proposed by prime brokers (whereby some SPVs are UK, others are US), it is hard to see what the Government could do without favouring a particular structure proposed by a particular prime broker. Although holding assets in bankruptcy-remote vehicles may facilitate a speedy return of assets in insolvency, there are, however, other considerations such as tax, netting and security interests which might impact the manner in which clients wish their assets to be held. However, as we have argued in our response under Question 39, we believe that the Government should as a priority consider focussing its efforts on supporting the ability of clients to distinguish, within their holdings with a

	prime broker, (1) client assets and (2) assets that are merely owed to the client by the prime broker. This effort would reduce the need to consider establishing a vehicle remote from any bankruptcy of other companies in the prime broker's group, although we recognise bankruptcy-remote vehicles do have other advantages and should thus be considered in parallel with other measures.
Question 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?**
Comments	The Lehman Bankhaus debacle has shown what an obvious loophole the client money rules permitted. The market has already moved on this, so that clients are requiring that client money is not held with affiliates – on the face of it, it would seem desirable to hard-code this into the rules. However, in a global industry, it is very difficult to see how restrictions on transfer of client money could be realistically viable. For example, if a client is invested in securities domiciled in a particular jurisdiction, invariably there will be a requirement to keep client money in that jurisdiction. If the proposals for reporting and record keeping are pursued and if the other proposals in the paper for protection of client assets are pursued, it ought not to be necessary to mandate that firms may not place client money with affiliates.
Question 46	**Should firms that manage client assets be required to obtain letters from custodians stating that there are no setoff and liens over client assets in respect of liabilities owed in a principal capacity by the firm?**
Comments	There should be a requirement for a statement of the degree of contamination risk/lien (ideally, there should be none) to enhance protection of client assets when they are held in accounts separate from managers' proprietary assets at the custodian level (although in collateral arrangements where title is transferred or a right of hypothecation exists, this will not be the case). As the sub-custody relationships/agreements are not transparent to clients, any encumbrances created by that relationship expose clients. The transfer of such rights of lien or retention to the investment bank's 'house' account with the custodian is likely to provide less certainty for the custodians and investment firms, where custodians may be exercising rights already granted over the house account. Investment banks may also seek to avoid using the same custodian as the client, to avoid this provision, providing no option to the custodian but to exercise its rights over the client account, except where such a letter is used. There should be further consideration of the cost implications of such a proposal before it is implemented as many cost efficiencies are achieved in current arrangements, where the assets are pooled at the custodian level.
Question 47	**Should firms be required to have the capacity to separately pool client money relating to riskier activities?**
Comments	Although such a proposal in principle would provide some protection for client money not related to riskier activities, following a short-fall in the client account, the FSA in CP38 put forward some sound reasoning on why

	the approach is not practical in reality:
	• Increased cost in establishing and maintaining the separate accounts; and
	• Increased time in retrieving segregated money due to:
	  o Establishing each 'pot's trust status, balance and client entitlement.
	  o The situation where multiple accounts would be needed for a single customer
	  o Higher compliance costs
	  o Transferring money between 'pots' to top up balances
	
	We suggest that this is an area which could usefully be revisited. Separate pooling will add to the complexity of client money arrangements, however, and could give rise to difficult situations.

Question 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?**
Comments	The absence of a bar date was one of the difficulties faced in the LBIE administration in respect of a speedier return of assets and was one of the elements highlighted as better in the US regime. However, in principle, a bar date to a proprietary claim is in the nature of an interference with property rights, so that justification for it is difficult to imagine. Once the law is sufficiently clear to facilitate speedy identification of client property, there should be no additional measure which would prejudice clients' proprietary interests in their property. The current limitations for claims should surely be adequate both to protect an individual's proprietary (or contractual) claims without, at the same time, being unduly onerous on firms. In a global industry, many claimants might take time to identify their rights to claim and then face many barriers to bringing timely claims – not least, by reason of the cross-border nature of modern investment banking. The Government should explain in much more detail the shortcomings of current limitation periods, before any proposal for change can be considered.
Question 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 over liens. Additionally there could be other 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; and** **• 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.**

Comments	We believe that these estimates are very conservative and the costs are likely to be significantly greater. To begin with, firms that tend to advise on these matters charge hourly rates considerably in excess of £300 per hour. Furthermore, renegotiation of contracts with custodians is likely to be particularly difficult and protracted and the time estimate therefore seems somewhat optimistic. A more realistic estimate of costs might be at least triple the amount set out in the consultation paper.
Question 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 'futureproof' and do they have a limited negative impact?**
Comments	The response to the collapse of Lehman Brothers has been understandably to assert significant focus on the protection of client assets. It is unsurprising that this should be the case, given the damage which flowed from the collapse. It should be remembered, however, that the technological developments which have facilitated a move to greater reliance on electronic trading, clearing and settlement systems and the increase in the volume of international securities which are dematerialised calls for a re-think of the appropriateness of the current general law regime to deal with the issues that these developments create. Much work has been done in this area by the FMLC, CEBS, CESR and other groups. In the 'altruistic' charge to prevent a repeat of the client detriment occasioned by the collapse of Lehman, it is all too easy to introduce a level of control in the system which will stifle the efficient operation of the markets. Ultimately, there is everything to be said for granting investors the right to control the nature of their interests in their assets in dealing with institutions and it should be the clients' prerogative to choose what the balance of cost efficiency versus security of entitlement should be. However, to impose a unitary approach to interests in securities and client money might not be the most appropriate trajectory on which the Government should embark. Building flexibility into the framework requires that clients have choices about the level of protection that might be available to them. The efficiencies of netting and set-off result in considerable cost savings which are not available in an environment where client title is recognised through the chain of custody. In that regard, it might be useful to remember that the outright title transfer methodology of collateral creation arose out of the English law requirement to register a floating charge – in the 1980s, the risk that a security interest could be voided for want of registration is precisely what drove the creation of the title transfer method of collateral creation. This illustrates the inventiveness of the markets to overcome fetters on market efficiency. In summary, we believe that legislation should be high level rather than granular because legislation can never keep up with market developments and innovations. However, where granular rules are implemented the client asset agency should review all rules on an on-going basis.
Question 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?**
Comments	The Government should ensure that London is not compromised as a competitive market by measures in this area and, therefore, it should not act in isolation of either Member States or other major financial centres in

	developing the law in connection with these matters. Before new rules are created, it is important for the existing Lehman Brothers case to be litigated; it has to date drawn out many helpful criticisms of the FSA CASS rules which will be the basis of some of the reforms. The Government should also leave the FSA to examine and propose further CASS amendments in its forthcoming consultation paper. The Government should explore the issue of whether clients' assets should be endowed with the status of trust assets under English law. We understand that the Government may lack the authority to do this under the current legislation being used for these proposals, but we believe that this should be explored. In the recent RAB Market Cycles court hearing, the judge found it hard to find a trust relationship in a prime brokerage relationship and there are some relatively unhelpful dicta ("if it is a trust, it is a very unusual type of trust", for example). The UK regime is predicated on the basis that English law provides sufficient protection through trust law, but there is at least one major prime broker that is unwilling to commit to saying that custody assets are held on trust. Such lack of certainty is unhelpful and damaging to UK plc. We also believe that the Government should consider attaching criminal liability to firms who seriously mishandle client money, with appropriate penalties - e.g., as apply in the US under the Commodity Exchange Act (max $1 million fine and/or 10 years in prison - see http://www.law.cornell.edu/uscode/7/13.html)
CHAPTER 5 – Providing clear and effective support For clients	
Question 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?**
Comments	Whilst the proposed powers and duties of the CAT as set out in paragraph 5.14ff would be helpful in speeding up the return of client assets, putting such duties with a separate CAT seems to be an excessive reaction to the crisis. It would be equally effective to alter the functions of the administrator to include much of the scope of the CAT's proposed function. Certainly, much more work on the cost benefit analysis is likely to be required before a definitive view could be formed. In particular, splitting the function between two office-holders will invariably lead to (a) conflicts and (b) duplication of efforts (e.g., when determining which assets are encumbered and which are unencumbered, or determining which encumbered assets can be returned to clients, both officeholders (acting in the interests of their respective constituencies) will invariably want to review all relevant records and come to their own conclusions - which will be a complete duplication of effort, time and costs). If a CAT is to be appointed at the discretion/application of the FSA, then we should question what happens for those firms in respect of which the FSA

	chooses not to appoint/request a CAT. Do the administrators of that firm then have the powers/duties that would otherwise fall to the CAT? Given the different interests of trust creditors and the general estate, it is unlikely that a firm would agree to take on both administrator and CAT roles. However, if the two are appointed from different firms, there will inevitably be less incentive for co-operation. We do not see the benefit of a separate office of the CAT; the same effects can be achieved by amending the administrator's duties.
Question 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?**
Comments	The advantage of the first method is the complete ring-fencing of client assets from contagion of the investment firm's insolvency, although this method will suffer from operational inefficiencies in running off the business of the insolvent firm. However, we query how the first method will sit with encumbered trust assets (which are usually subject to liens based on the possession of assets by the insolvent firm). The second method is less secure than the first but offers more flexibility about business run-off and settlement of outstanding positions.
Question 54	**Should the costs of the CAT be funded from the client money and assets of the firm, or from the insolvent estate?**
Comments	If the firm has failed to meet the CASS requirements, then there is no reason why the client fund should be burdened with the costs of the CAT. Perhaps the idea of having an "insurance" fund, as we understand is the case for SIPA in the US, would work better. Whilst clients of LBIE are generally willing to meet the costs out of their custody assets, this does not seem to be a good long-term solution.
Question 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?**
Comments	No. It is an excessively bureaucratic development which would duplicate effort and cost, give rise to further opportunities for conflicts and could be just as effectively achieved by altering the objectives of the administrator. The Chapter 2 proposals would be preferable. See under Q 52 above.
Question 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.**

Comments	No. The problems with non-compliant record-keeping and reporting will result in legal uncertainty, which needs to be clarified in order for the CAT to function properly. In addition to the costs of maintaining the CAT, we do not see how there will be a significant change in the costs associated with resolving uncertainties. As noted above, in determining the various matters that fall within the scope of the CAT's proposed duties (paragraph 5.14 ff), the relevant due diligence/reconciliations and interpretation of the books and records will invariably be duplicated by both the CAT (on behalf of the trust creditors) and the administrator (on behalf of the general estate).
Question 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?**
Comments	Yes.
Question 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?**
Comments	Yes but it should be an integral part of the FSA (not distinct from it), comprised of individuals who are currently focused on this area.
Question 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?**
Comments	Yes – although a right to vote may be difficult to implement in practice.
Question 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?**
Comments	Yes.
Question 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?**
Comments	This seems sensible, as long as the CAA would not take to establishing an agenda that will involve it in producing more and more research and material, which will inevitably lead to ongoing high costs.
Question 62	**Do you have any other views on the establishment of a CAT or CAA that the Government should consider?**
Comments	If the FSA personnel currently engaged in client asset matters were

	supplemented with additional headcount to enable proper supervision of firms in this area, there would be no need for the creation of a new agency or for the creation of a CAT.
CHAPTER 6 - Reconciling counterparty positions	
Question 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 to address incorrect TSO flagging, 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.**
Comments	AIMA has no comment.
Question 64	**What action should market participants take to address incorrect TSO flagging? Do you believe regulatory action to address the issue of TSO flagging is needed?**
Comments	AIMA has no comment.
Question 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 for all affected parties, including creditors? What other options should the Government consider?**
Comments	AIMA has no comment.
Question 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?**
Comments	AIMA has no comment.
Question 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?**
Comments	AIMA has no comment.
Question 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?
Comments	AIMA has no comment.
Question 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.**
Comments	AIMA has no comment.
Question 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?**
Comments	AIMA has no comment.
Question 71	**Are there any other solutions the Government should be considering to promote margin portability?**
Comments	AIMA has no comment.
Question 72	**Initial 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 also 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.**
Comments	AIMA has no comment.
Question 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?**
Comments	AIMA has no comment.

Question 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?**
Comments	AIMA has no comment.
Question 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.**
Comments	AIMA has no comment.
Question 76	**Does EUI's proposed approach to settlement provide greater predictability and are there ways it could be improved?**
Comments	AIMA has no comment.
Question 77	**Have the key consequences of EUI's proposal to increase certainty of settlement been identified correctly and do the benefits for the market as a whole of the proposed revised approach outweigh these consequences?**
Comments	AIMA has no comment.
Question 78	**Do you believe that Government action is required to address contractual terms issues?**
Comments	AIMA has no comment.
Question 79	**If you do believe regulation or legislation to address terms of business between investment firms and investment manager is required, which issues do you think are the highest priority? Which types of measures would best address them?**
Comments	AIMA has no comment.
CHAPTER 7 - Managing complex creditor positions	
Question 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?**

Comments	Section 2(a)(iii) of the ISDA Master Agreement is a very important provision. We do not believe that this should be the subject of legislative action, even if a market solution is not found.
Question 81	**Do you agree with the proposal for a resource centre to aid administrators of investment firms?**
Comments	AIMA has no comment.
Question 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?**
Comments	AIMA has no comment.
Question 83	**In relation to the areas listed here, 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?**
Comments	AIMA has no comment.
Question 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 here and which the Government should consider?**
Comments	AIMA has no comment.
ANNEX C – Consultation Stage Impact Assessment	
Question 85	**Do you have any suggestions which could help improve the Government's proposed quantification strategy? If so, please specify what these are.**
Comments	AIMA has no comment.
Question 86	**Are you able to provide an estimate of the financial impact of any delays or issues with LBIE's resolution process on your firm, as a counterparty, client and/ or creditor? If so, please provide an estimate for losses in the areas below, and what caused them. Please give the Government an idea of your firm's size.** **• For counterparties, please provide any information about the cost to your firm of uncertainty about what would happen to trades at trading,**

	clearing and settlement, inability to hedge exposures, and the need to double-margin. **• For clients, please provide any information on resources allocated to sorting out an investment bank failure, and any cost from inability to use capital and assets tied up in the investment firm.** **• For unsecured creditors, please provide any information about losses caused by destruction of the intrinsic value of the firm's estate as a result of events occurring after the administration.**
Comments	AIMA has no comment.
Question 87	**Are you able to provide any information which might help the Government quantify the ongoing or broader 'ripple' impacts of issues with the resolution process of a failing investment firm as described above? If so, please provide an estimate.**
Comments	AIMA has no comment.
Question 88	**Are you able to provide any information that would help the Government to assess the loss of confidence caused by any problems with the resolution process itself, as described above? If so, could you please provide an estimate of costs associated with the loss of confidence?**
Comments	AIMA has no comment.
Question 89	**By what percentage do you believe the proposals in this document might reduce any issues associated with the resolution process for an investment firm? Do you agree that, as a minimum, the overall package of measures proposed has potential to reduce any difficulties by 50%?**
Comments	AIMA has no comment.

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15th March 2010

Investment Banking Resolution
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Dear Sirs

Establishing resolution arrangements for investment banks

The Association of Private Client Investment Managers and Stockbrokers (APCIMS) represents firms acting on behalf of investors[1]. Member firms deal primarily in stocks and shares as well as other financial instruments for individuals, trusts and charities and offer a range of services from execution only trading (no advice) through to full portfolio management. Our member firms operate on more than 500 sites in the UK, Ireland, Isle of Man and Channel Islands, employing 30,000 staff. Around £335 billion of the country's wealth is under the management of our members.

Our member firms are subject to MIFID and the CRD and the majority are defined by the FSA as 'small firms'. Our firms primarily act as agency brokers and the vast majority of trades on behalf of private clients are undertaken on regulated markets with defined default arrangements. Most transactions are in UK shares, bonds or packaged products. Most of our members are strictly agency brokers; the very few firms that do take positions do not take material positions relative to the size of their balance sheet. Our member firms do not undertake proprietary trading or engage in prime brokerage activities. Compeer, an organisation that compiles market data for our sector indicate that the market value of investment assets held on behalf of all clients (professional and retail) within our sector is as follows:-

	2007	2008	% Change
Investment Assets - £ billion	403	335	-16.9%
Direct securities held in custody	248	198	-19.9%
Collectives	107	90	-15.6%
Alternatives	28	26	-7.5%
Cash	21	21	-0.1%

Historically very few agency brokers in our sector have defaulted. Claims on the compensation scheme have tended to be for unsuitable investment advice rather than misappropriation of assets. Where claims have arisen for misappropriation of assets the firms giving rise to such

[1] APCIMS has around 190 members, over 125 are private client investment managers and stockbrokers and the rest are associate members providing related services to our firms.

claims generally failed to comply with the existing FSA rules. We do not believe the proposals in this consultation paper would have mitigated the position

We are grateful for the discussions we have had with HM Treasury following the publication of the consultation paper. Our key concerns are as follows:-

<u>The scope of the proposals</u>

Most of our member firms would **NOT** meet the conditions set out at 1.25 of the consultation paper as they do not have the permission 'dealing as principal'. However, we are still unclear as to the exact scope of the proposals and our discussions with HM Treasury indicates that firms without the permission 'dealing as principal' may still be caught by these proposals. It is vital that it is clear what firms are intended to be caught by these proposals and that any proposed rules brought forward by the FSA in response to this paper clearly explain what firms are, and are not, subject to any rules. A number of the proposals relate to systemic investment firms but the criteria for identifying such firms is not set out in the paper.

Our view is that our firms do not give rise to systemic risk; we would propose that only ILAS non exempt firms should be caught by these proposals as defined by BIPRU 12.1.4[2]. In addition firms within this proposed scope whose business models are 'simple' (ie the material part of their business is agency broking on regulated markets) should be able to seek a waiver from the FSA from the proposed rules if they do not give rise to systemic risk.

<u>'One size fits all'</u>

We understand that the major driver in bringing forward these proposals is to address the issues arising from the default of Lehman's. We fully understand the desire of Government to ensure action is taken to ensure lessons are learnt from the default of Lehman's. In conducting the market failure analysis of Lehman's it is essential that Government dose not adopt 'a one size fits all' approach to other investment firms whose business model is totally different to Lehman's.

Our general criticism of the consultation paper is that whilst it states at 1.24 that the Government '*notes the need for any policy proposals to be applied proportionately, and to avoid placing undue burdens on smaller firms'* there is little or no information in the detailed proposals to enable small firms to understand how the proposals will be applied in a proportionate manner and to understand the obligations being placed upon them. We have found it very difficult throughout the paper to ascertain the impact on our sector. For example, paragraph 4.86 states *' Finally, it is important to note that the relationships in question in this chapter involve sophisticated investors, who professionally negotiate documentation, often utilising external counsel. The Government is not seeking to undermine the fundamental commerciality of such arrangements'.* Yet, as our response to the questions in Chapter 4 makes clear, the proposals impact on small investment firms and their retail clients.

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2 BIPRU 12.1.4

(1) An exempt full scope BIPRU investment firm is a full scope BIPRU investment firm that at all times has total net assets which are less than or equal to £50 million.

(2) In this rule, total net assets are the sum of a firm's total trading book assets and its total non-trading book assets, less the sum of its called up share capital, reserves and minority interests.

(3) For the purpose of (2), the value attributed to each of the specified balance sheet items must be that which is reported to the FSA in the firm's most recent FSA001 data item.

Cost benefit analysis

The costs and benefits in the paper have not been assessed in the context of our sector. In the absence of any consultation with firms within our sector, it has not been possible to comment on the accuracy of the costs. However, if we assume the costs quoted in the paper in respect of the proposals are accurate, the impact on small investment firms will result in very material costs impacting on their business. In the event that the proposals in this paper fall upon small firms additional work must be undertaken to assess the impact. We are strongly of the view that the costs of these proposals will outweigh any benefits in respect of our member firm's business models.

Interaction with the Markets in Financial Instruments Directive

The rules governing client assets and client money are set out is FSA's CASS handbook; they are essentially a 'copy out' of the provisions in the Markets in Financial Instruments Directive. There is no indication in the paper as to how the proposals interact with existing European Directives and for example, whether or not submissions would be required under Article 4. We are supportive of MIFID and it is important that any proposals brought forward by HM Treasury reflect development in Europe, such as the current review of MIFID, and do not undermine the objectives of MIFID of a level playing field throughout Europe.

Client Asset Agency

We are strongly opposed to the creation of a client asset agency within the FSA. We believe the Board and management of the FSA should determine the structure for meeting their regulatory objectives. It is appears to us illogical to create a separate agency for one aspect of the FSA's responsibilities determined it appears to us by the latest regulatory crisis i.e Lehmans.

Some general comments on the main chapter headings are set out below.

Enabling an orderly resolution

We are broadly supportive of a new administration regime for a failed investment firm.

The requirement to have recovery and resolution plans for individual firms will be exceedingly onerous for our member firms and we are of the view that costs of these proposals outweigh any benefits. The proposals should only apply to very large firms who give rise to systemic risk. We have significant reservations as to the extent to which the appointment of 'business resolution officers', 'investment firm resolution plans', and 'business information packs', will actually assist an administrator. There are numerous examples of firms who have defaulted who failed to comply with regulatory rules which if they had done so would have resulted in an efficient administration process. There is no reason to believe that the imposition of further regulatory requirements will alter the position in future. Has any analysis been undertaken as to whether or not there were shortcomings in Lehman's adherence to the FSA's existing rules which has hampered the administrator? For example, the market believes that contrary to the rules Lehman's were issuing contract notes to clients indicating they had dealt on a regulated market when in fact the trade was an OTC trade which has created significant problems for the administrator in determining the contractual obligations in respect of the trade.

We are unclear how the proposal to hold a 'liquid operational reserve' will operate given the FSA's proposals in respect of capital planning buffers. The FSA already plays great attention to the firm's estimate of the costs of an orderly wind down of their operations as part of their supervisory review of the ICAAP process. We believe the existing prudential rules address the

Government concerns; this proposal is in danger of duplicating existing rules and bringing in an element of double counting in terms of the capital requirements.

<u>Reconciling and returning client money and assets</u>

We are unclear how the proposals in this section link in with firms' existing obligations under the FSA rules. For example, COBS 6.1.7 already sets out the information concerning safeguarding of designated investments belonging to clients and client money to be provided to clients. Many of the rules relating to client assets are derived from MIFID and the consultation paper makes no reference to this fact and does not indicate what notification would required to meet the UK's obligations under Article 4.

We question the need for a control function specifically responsible for client money and assets. We are unclear as to the scope of this proposed role particularly where a firm as combined settlement and custodian activities. For example, who would be responsible for processing client money as part of the settlement process the settlement director or the client asset officer? What is meant by the term 'fully qualified' in respect of the person fulfilling the role of client protection officer?

<u>Reconciling counterparty positions</u>

We recognise the importance of ensuring the contractual obligations in respect of a trade are clear; as already mentioned most of the trades undertaken by our member firms are on regulated markets which have defined default rules. We are concerned about the proposal to introduce a requirement for investment firms to offer facilities to segregate client business. We are unclear as to the impact of this proposal on our member firms business models.

We attach as an appendix to this letter our response to the detailed questions in the consultation paper.

In conclusion we would reiterate the importance of the Government determining as a matter of urgency what firms are caught by these proposals and of ensuring that it maintains a dialogue with <u>all</u> within the scope of the proposals.

Please do not hesitate to contact us if you wish to clarify any points arising from the content of this letter and accompanying appendix.

Yours faithfully

Ian Cornwall

Ian Cornwall
Director UK Regulation

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

The definition is far too wide and includes many investment firms whose business model and associated risks are totally different to Lehman's and similar 'investment banks'. Consequently, this has resulted in 'a one size fits all approach' in formulating proposals with no consideration of the fact that nature scale and complexity of firms' business models differ and lack of information has to how the Government plans to implement the proposals in a manner that is relevant, appropriate and proportionate.

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

The analysis supporting the proposals for special administration objectives refers to, amongst other things:-

2.6 Investment firms are a core part of the national and international financial infrastructure, and among other things, play a critical role in providing market liquidity. A freezing of credit markets and a substantial strain on financial stability have followed the recent failures of investment firms, along with the failure of retail banks.

2.8 This is a consequence of the complexity of investment firms' business, with balance sheets generally consisting of money and assets held on trust for clients, complex counterparty and financing positions, and collateral assets and liabilities in addition to other assets and liabilities. A single external party can have multiple types of claims on the assets of the investment firm at any given time. In many cases, rights of set-off and netting exist that pose difficulties for reconciliation.

The size and nature of our member firms activities is that such that they do not give rise to systemic risk; they act as agency brokers and much of the above analysis is not applicable to their business models. Our member firms do hold client money and client assets but these are held off balance sheet.

We would refer you to our general comments in our covering letter.

Question 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?

No comment.

Question 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?

No comment.

Question 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?

No comment.

Question 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?

No comment.

Question 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 financial stability? What specific modifications could the Government consider applying?

No comment.

Question 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 described in Box 2A?

No comment.

Question 9
Is there a case for considering 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?

We are unclear as to the extent these proposals will be applicable to our member firms' business models. The firms open positions are in respect of private client transactions undertaken on an agency basis, most of the trades will have been undertaken on regulated markets with defined default rules and many trades will be settled via CREST.

Cost-benefit analysis - Question 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

We are unable to make an assessment of the costs.

Question 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.

We think that communication can broadly be distinguished between messages directed at the systemic impact arising from the default of the firm and detailed operational messages focussing on the completion of open trades and clients with a counterparty risk exposure to the firm. Thus the communication strategy needs to be directed more widely than just market participants and needs to include clients. For example, what messages should have been given and when to holders of Lehman's structured products? We would expect equal weight to be given to the concerns of individuals in the event of a default and a communication strategy that ensures that relevant information is on the FSA's Moneymadeclear website and the Financial Services Compensation Scheme website. Investment firms may receive questions from clients and the ability to refer them to a website run by the regulatory authority is important to ensure they receive valid information.

Cost-benefit analysis - Question 12
The Government considers the costs to market participants of a resource centre providing best practice guidance to administrators, and plans for coordinated 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

We are unable to make an assessment of the costs.

Question 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?

No comment.

Question 14
Are there any other specific issues in relation to cross-border investment firms, not considered here or in Chapter 8, that need to be addressed?

No comment.

Question 15
The Government welcomes views on the extent to which the package of measures proposed in Chapters 2 and 3 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?

No comment.

Question 16
Do you have views on the coverage or detail of the BRO's responsibilities as outlined here?

Are these consistent or compatible with existing templates for the corporate governance structure of firms?

It is impossible from the information in the paper to understand how the proposals will be applied proportionately. We note the comment that '*the size and complexity of investment banking activity pose substantial difficulties for investment firm resolution both before, during and subsequent to any failure.'* but our member firms business models do not give rise to systemic risk and are not complex.

Question 17
Do you agree with the basic policy of establishing a role for business resolution officers 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?

We do not agree with the basic policy of establishing a business resolution officer in respect of our member firms business models. The Government proposals are based on a 'one size fits all' approach with no appreciation that many small investment firms are within the scope of the proposals. Some small firms employ less than 20 staff.

Question 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?

We would refer you to our response to question 17 above.

Cost-benefit analysis - Question 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

As far as we are aware there have been no discussions with small investment firms on this issue. We believe that costs of implementing these proposals for small firms will be significant and far outweigh any benefits.

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

It is impossible from the information in the paper to understand how the proposals will be applied proportionately. Most of the actions set out in 3b and 3c are simply not applicable to our firms' business models – they act as agency brokers for private clients and hold client money and client assets.

Question 21
What are the obstacles to implementing investment firm resolution plans as suggested in this document? What policies could the Government consider to address these, if any?

No comment.

Cost-benefit analysis - Question 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 outlined here, do you agree with the suggested costs for the prime brokerage business?

Our member firms are not in the prime brokerage business.

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

Given the dearth of information as to how these proposals will be applied proportionately to small investment firms we cannot estimate the costs. Our view is that the costs will be significant and outweigh any benefits. Many small firms would need to seek external advice and assistance.

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

We agree that business information packs would be useful to administrators if they are accurate at the time of the firm's default but the costs of maintaining this information would outweigh any benefits. Please also refer to the comments in our covering letter.

Cost-benefit analysis - Question 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.

As in the case of resolution plans, there may be ongoing benefits to the investment banking business from having in place continually updated BIPs, but these are not included here.

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

Our member firms are not in the prime brokerage business.

Question 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.

Given the dearth of information as to how these proposals will be applied proportionately to small investment firms we cannot estimate the costs. Our view is that the costs will be significant and outweigh any benefits. Many small firms would need to seek external advice and assistance.

Question 27
The Government would welcome views on what incentives and disincentives are likely to be effective and whether there are any concerns with the ones suggested above.

No comment.

Question 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?

No comment.

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

No comment.

Cost-benefit analysis - Question 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 crossborder 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 renegotiating contracts for both staff and suppliers to be in the region of £40,000 to £200,000. Although it is possible that these costs may be higher, the Government understands that they are unlikely to be as substantial as costs of on-shoring systems and services. The cost implications of associated policy measures such as an operational reserve for the payment of staff and essential services, the BIPs and BRO are examined in the relevant policy sections.

Do you agree with the cost estimates suggested above, for contractual provisions for key staff and suppliers? What are your views on the incremental costs of: (i) renegotiating 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?

Given the dearth of information as to how these proposals will be applied proportionately to small investment firms we cannot estimate the costs. Our view is that the costs will be significant and outweigh any benefits. We are unclear whether 'stakeholders' would include small investment firms.

Question 31
What alternative policy tools 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?

No comment.

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

We have significant reservations about this proposal. We would refer you to our covering letter which addresses this issue.

Cost-benefit analysis - Question 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 the cost estimates suggested above? 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?

We are unaware of any discussions with stakeholders in our sector.

Question 34
Do you have any views about the operational reserve proposed here?

We would refer you to our covering letter which addresses this issue.

Question 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?

We would welcome clarity over how shortfalls in client asset omnibus accounts should be treated upon insolvency and when clients' entitlement to their assets should be treated.

Question 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?

Rehypothecation is not an issue for our member firms but our members do operate client omnibus and/or clients designated named accounts. We note the issues set out in paragraphs 4.35 - 4.37 in respect of omnibus accounts, however there is no consideration in the paper of problems that can arise in respect of designated accounts. Failure to operate designated accounts properly can equally result in delays in making payments to clients. The integrity of the accounting records for both omnibus and designated accounts is the prime factor in determining prompt payments of client assets. Whilst all client share in the loss as a result of shortfalls in the omnibus account a shortfall in a designated account is fully borne by the client.

We note FSA COBS 6.1.7 addresses this issue. Please refer to our covering letter for further comments.

We do not believe firms should be compelled to offer designated named accounts at custodians. In the event that firms were compelled to offer designated accounts it would result in additional costs to the client. In addition, further work needs to be undertaken to determine the extent to which designated accounts are practical for overseas holdings. The manner in which securities can be held in local overseas markets vary and designated accounts are not always practical in terms of the ability to execute and settle trades. For example, if firms were forced to operate designated accounts would this mean that bearer bonds would have to registered in the clients own name? In many markets there are significant difficulties in trying to sell bearer bonds in the name of an individual compared to bearer bonds in a 'good marking' name.

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

We support the Governments' aim to encourage clarity in contractual agreements. We have no specific suggestions as to the best way of achieving this objective.

Cost-benefit analysis - Question 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.

We are unclear what consultation has taken place with firms within our sector. As already mention we do not believe rehypothecation is an issue for our firms but they do operate omnibus accounts. 'Warnings' on omnibus accounts carries a negative connotation. We have no objection to clients being made aware of the manner in which their client assets are held. There are advantages and disadvantages associated with both omnibus and designated accounts and clients should be provided with full information. We believe the costs set out above are reasonable in terms of legal fees. However, if existing clients need to be notified of further information beyond the existing requirements then the costs above fail to take account of the costs of printing and mailing information to clients. A one way notification costs about £1.50 per client but that cost could double if a two way agreements are needed - i.e. client signature is required. Some of our large members will have a database exceeding 100,000 clients.

Question 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?

The Government proposal fails to define 'systemic investment firms'. Our view is that our member firms should not be within the scope of these proposals.

Question 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?

Most of our member firms' custody systems are integrated with their settlement systems. Information regarding trades is therefore readily available. There needs to be much greater clarity as to the actual nature of the record keeping obligations being placed upon firms by these proposals to enable firms to assess the potential impact. For example, an integrated settlement and custodial system enables details of trades and stock movements to be readily ascertained. However, an obligation to record both trade and settlement details on a custody statement would be a major system change resulting in firms incurring considerable costs.

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

We cannot ascertain from the consultation paper the nature of the increased audit disclosures that are being proposed; as such we cannot express view on this issue. The text appears to suggest there is a concern with the quality of audit reports rather than the content of the audit report. At present there is no materiality threshold in the report and a very minor breach will result in a qualified audit report. In terms of making available audit reports to clients there should be a mechanism for ensuring full information is presented including a firm's response to any issues raised in the report.

A further issue for consideration is in respect of CASS audit reports and the issue of the liability of auditors in the event they issue a negligent report. Clients will take some comfort from the fact that CASS activities are subject to an independent audit. There is no recourse available as we understand it from a firm or its clients to the auditor if they issue a negligent report because the report has only been addressed to the FSA who will not suffer a loss in the event that assets are misappropriated.

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

We do not believe that the creation of a control function for CASS oversight will strengthen the control environment. We also have reservations to the extent such a control function is relevant for small investment firms. We would also refer you to the comments in our covering letter.

Cost-benefit analysis – Question 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.**

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

As previously mentioned, we are unclear what discussions have taken place with investment firms within our sector. As we set out in our response to question 40, there is currently a lack of information within the consultation paper to enable firms to clearly understand the precise nature of the system changes being proposed. The costs quoted above will be very significant for small investment firms.

Question 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?

No comment – our member firms do not use such vehicles.

Question 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?

We are supportive of the proposal but would like to see further analysis to ensure there is no unintended consequence in terms of the settlement of overseas transactions.

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

CASS 6.3 already addresses this issue and is derived from MIFID; are changes to this rule envisaged as a result of this proposal?

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

We do not support this proposal and think it is impractical to operate.

Question 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?

We recognise the benefits of a bar date. In determining the timing of a bar date it needs to be of sufficient length to enable individuals to have sufficient time to respond.

Cost-benefit analysis - Question 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 over liens. Additionally there could be other 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 of requiring firms to have the ability to divide client money into separate pools, depending on the extent to which firms already have this capability. There could also be an annual maintenance cost to firms of around £750,000 to maintain these separate pools; and**
- **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.

We are unable to ascertain the costs of these proposals for our sector.

Question 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 'futureproof' and do they have a limited negative impact?

At present the CASS rules are derived from MIFID and we are concerned that the Government does not 'goldplate' MIFID or forces firms to take actions which may shortly be overtaken by proposals from the European Commission.

Question 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?

No comment.

Questions 52 to 56
Client asset trustee would only apply to a systemic investment firm; we are assuming our member firms are not within this category.

Question 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?

No comment.

Question 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?

We are concerned about the creation of the CAA. We are not clear how it will impact on small investment firms. We do not believe that having a regulatory agency within the FSA only focusing on client money and client assets is the correct approach and we strongly favour keeping responsibility with the FSA. We are unclear where the boundaries between the FSA and CAA would be drawn. For example would the daily client money settlement reconciliation be the responsibility of the FSA or the CAA? In the event the Government wishes the FSA to place greater emphasis on client assets and client money it should consider amending their statutory objectives. The proposals seem illogical why have separate part of the FSA focussing on this issue but not the provision of suitable advice? Why single out just one regulated activity for a separate regulatory process?

Question 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?

We have reservations about this proposal and are unclear as to the exact nature of the duties and obligations being imposed on the FSA and the basis upon which they can challenge the administrator whom we understand is accountable to the Court.

Question 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?

We are strongly against this proposal and can see no merit in setting up another regulator for client assets.

Cost-benefit analysis - Question 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?

Our understanding is that the FSA allocates its resources by reference to its statutory objectives. We are not supportive of the creation of the CAA.

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

Please see previous comments.

Cost-benefit analysis - Question 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 to address incorrect TSO flagging, 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.

We do consider this to be a significant issue for our firms.

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

No comment.

Question 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 for all affected parties, including creditors? What other options should the Government consider?

No comment.

Questions 66 to 73
Not applicable to our member firms' business models.

Question 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?

We do believe this proposal should be applicable to retail clients undertaking transactions on a regulated market. To what extent does the client right to determine the clearing arrangements interact with the firm's obligations to achieve best execution under MIFID?

Questions 75 to 84
No comment

ESTABLISHING RESOLUTION ARRANGEMENTS FOR INVESTMENT BANKS

Comments by the Association of Business Recovery Professionals ('R3') In response to the consultation document issued by HM Treasury in December 2009

Introduction

1. We previously commented on the first consultation document on this subject issued in May 2009. In this response we confine our comments to those issues which come within the direct experience of our members in the course of their work as insolvency practitioners.

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

2. The consultation document is written from the point of view of the Lehman Brothers collapse, and the proposed resolution arrangements have clearly been formulated with a view to their application to large and complex firms. However, a regime which is suitable to the collapse of a firm like Lehman's, would not necessarily be suitable for a small stockbroker, which operates as a much simpler business. The proposed special administration regime is so different from the existing administration regime that it must safely only apply to firms of a size which justify such enormous pre and post insolvency measures and their associated costs. Although this may not be so if the bulk of the pre-insolvency measures are not ultimately introduced, the conditions set out in paragraph 1.25 appear to us to give rise to the potential to include too many small firms. Although the requirement for investment banks to maintain investment firm resolution plans must be welcome for large cases, the cost could prove to be anti-competitive for small firms wishing to enter the market, and present unacceptable costs for those wishing to compete against overseas firms. Some thought therefore needs to be given to the question of proportionality, and whether there needs to be a cut-off based on size of firm.

Question 2 - Do you agree with the Government's proposals for special administration objectives and associated policy measures?

3. We agree with the objectives, except for the reference to the Client Asset Trustee, on which we comment further in paragraph [23]. It is important that the priorities are clearly spelt out, so that the administrator can pursue the

objectives without risk of attack. We presume that objectives 1, 2 and 3 are prioritised over objective 4, otherwise objective 4 could be inconsistent with the others.

Question 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?

4. If the priority is to be the handing back of client assets, it is important that the administrator should be adequately protected for doing so. This means that the administrator should have greater protection than under the normal administration regime. Restricting the protection to negligence claims would be inadequate, and an indemnity out of the assets would be of limited use because they would be quickly moved on in the market. The best form of protection would be statutory immunity from suit where the administrator is acting in good faith.

Question 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?

5. We would take limited comfort from this. The position of company directors and insolvency office holders is very different. Moreover, the law relating to the liability of directors is far from clear. Directors are to be judged by reference to general knowledge and skill of the particular director and they will have had a duty to be familiar with the company for longer than the administrator. We prefer the idea of a statutory hold-harmless as outlined above.

Question 5 - Do you agree with the Government's approach to the court process for clarification around liability?

6. We see no need for this if our suggestion of a statutory hold-harmless is adopted. In this connection we would add that any procedure involving investment banks should be dealt with by the High Court in London, which has the necessary experience.

Question 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?

7. It is important to make it clear that the administrator is protected from liability, not only when dealing with the company's assets (as provided by section 234 of the Insolvency Act 1996), but also third party assets.

Question 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 financial stability? What specific modifications could the Government consider applying?

8. There are difficulties in moving away from the standards which apply to directors' conduct generally. We can see the case for providing a defence against actions for preferences etc to enable directors to implement resolution plan actions. However, if they are acting at the behest of the regulator, that should be sufficient protection. Once the FSA becomes involved, the directors' liability should be limited, as they no longer have control of the conduct of the business.

Question 9 - Is there a case for considering provisions in the special administration regime for investment firms in relation to new financing?

9. We doubt whether this is practicable, or that sources of funds will readily available.

Question 10 - Cost-benefit analysis.

10. With regard to costs, subject to the manner in which it is intended to dovetail the proposed regime with the bank insolvency procedure, the costs are not likely to be significantly different from pursuing an administration of an investment bank under the current regime. As to benefits, we understand that in the case of Lehmans a hold-harmless for the administrators would have considerably reduced the time spent on identifying and returning client assets. Such a measure would therefore be a benefit to the estate in terms of cost savings, but this cannot be accurately quantified.

Question 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.

11. We are opposed to the idea of a resource centre for the reasons given in answer to question 81. Communication should be a matter for the administrator, who will use whatever is the most appropriate method in the circumstances of the particular case.

Question 12 - The Government considers the costs to market participants of a resource centre … to be negligible … Do you agree with the cost suggested in the paragraph above?

12. As we are opposed to the idea of a resource centre, we take the view that there should be no associated costs.

Question 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?

13. We see nothing wrong with this idea, but question why an entity regulated in another jurisdiction should be able to choose which insolvency regime should apply.

Question 15 - Do you believe there is a case for the measures to be further enhanced by a special resolution regime for investment firms?

14. Since the measures proposed involve a special order of priorities which departs from the normal purposes of administration, it follows of necessity that there has to be a special resolution regime.

Question 17 - Do you agree with the basic policy of establishing a role for business resolution officers 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?

15. The responsibilities of the business resolution officer should cease as soon as an administrator is appointed, but otherwise we are broadly supportive.

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

16. Yes. However, in view of the abnormal nature of the resolution actions, it will become clear to the market very quickly when the firm starts to implement a resolution plan. It is unrealistic to suppose that the market will not realise the implications.

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

17. Business information packs will be useful, provided that they are up to date and accurate.

Question 27 - The Government would welcome views on what incentives and disincentives are likely to be effective and whether there are any concerns with the ones suggested above.

18. We are not sure how effective the suggested incentives and disincentives would be .The suggested clawback of remuneration seems particularly questionable. A better approach might be to put pressure on purchasers to make key staff available to provide essential services back to the insolvent firm.

Question 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?

19. Additional key areas would be human resources and health and safety (unless these are included under 'tax and legal').

Question 29 - What do you consider would be an appropriate measure to ensure that the fees that suppliers charge post-insolvency are not inordinately high?

20. R3 has argued elsewhere that providers of essential services should be prevented from using their position to extract ransom payments as a condition for allow continued use of their products or services during an administration. Section 233 of the Insolvency Act deals with this to some extent in the case of utilities supplies, but the problem is far wider and includes licensors of IT services such as those identified in the consultation document. A further problem is that it is not always clear from IT licensing documentation which parts of the firm are entitled to use it. It would be helpful for the administrator to have a hold-harmless in cases of accidental contravention of IT licences. Another problem area is data confidentiality. Data belonging to different parties may be commingled, leading to accidental breach of confidentiality. This is another area in which administrators need protection.

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

21. We agree that the operational reserves should be available to meet the expenses of administration, as indicated in the document. In small cases, the operational reserve might be the only fund available to meet such expenses.

Question 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?

22. Yes. Client assets should be held outside the group. If they are held with affiliates, they are not protected if the whole group goes down.

Questions 53ff - The client assets trustee

23. We are opposed to the idea of the Client Assets Trustee. To have a separate officer acting in parallel with the administrator seems not only unnecessary, but potentially damaging. The purpose for which the CAT would be appointed is already catered for by the special objectives of the administration procedure. The appointment of a CAT would be unnecessary duplication, would entail added costs, and would give rise to the potential for disputes and delay.

24. If, despite these clear disadvantages, it is decided to proceed with this idea, then the CAT should be appointed from the same insolvency practice as the administrator.

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

25. Any costs should be paid out of client assets; otherwise clients are essentially receiving a free service at the expense of the general creditors.

Questions 57ff - The client assets agency

26. There is no need for a client assets agency if there is no client asset trustee, and we are therefore equally opposed to the idea of a CAA.

Question 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?

27. As identified in the consultation document, the inability to close out contracts can cause major difficulties for administrators. In our view the defaulting counterparty should have the ability to terminate derivatives contracts in order to avoid these problems. We would prefer to see this achieved by way of a market solution.

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

28. We are opposed the idea of a resource centre, and believe it is unnecessary. Administrations of complex investment firms should only be undertaken by insolvency practitioner firms with the necessary skills and resources. In any event the administrator can buy in any specialist expertise needed for specific tasks. The establishment of a resource centre would merely duplicate the already existing expertise, and would add to the cost without bringing any commensurate benefit.

Association of Business Recovery Professionals
16 March 2010

The voice of banking
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ESTABLISHING RESOLUTION ARRANGEMENTS FOR INVESTMENT BANKS

BBA Response to the HM Treasury Consultation Document

The British Bankers' Association (BBA) welcomes the opportunity to comment on the latest consultation document issued in December 2009 – this follows our response to the May 2009 consultation.

This memorandum focuses on what are judged to be some of the key issues raised in the consultation. Responses to the specific questions posed in the consultation paper are appended.

Clearly the Lehmans experience and related events have posed a range of very different questions and issues for both the authorities and the market and it is helpful to have these presented in turn in the consultation paper. We are appreciative of the open and considered manner in which the Government has sought to consult on the issues raised in the paper. Before addressing the detail of the consultation we would make a number of high level points:

- In a variety of areas the key test will be to strike an appropriate balance between furthering the resolution objectives and maintaining the competitiveness of UK based firms and service levels. As the consultation paper notes this will require the application of rigorous costs benefit analysis, which needs to be made in the context of regulatory change as a whole.

- The scope for competitive distortions as between markets, and for regulatory change to increase the cost of credit and impede the recovery of the wider globally, will be greater the less ambition is shown by key jurisdictions and international bodies in working towards globally coordinated responses to the financial crisis and its aftermath.

- In terms of the challenges identified we believe that in many areas market led initiatives have a key role to play in facilitating flexible and durable solutions. We are pleased that this is recognised in the consultation paper.

- The consultation paper is fairly light on detail as to the interplay between the special administration regime and the Banking Act special resolution regime, which will be crucial in respect of firms undertaking both investment and deposit taking business. This will be a key matter for consideration pending the further consultation scheduled for later in the year.

Enabling an Orderly Resolution

1. We are in broad agreement with the proposed special administration objectives (SAOs). However, whilst we understand the intention to prioritise the return of client assets, it would be helpful to spell out the implications of the statement in Paragraph 2.21 of the consultation paper that each of the other three objectives could take precedence over winding up the bank in the interests of creditors as a whole. Also, it will be important to make clear that the application of the precedence principle

should not unreasonably fetter the discretion of the administrator. We would in addition query whether the creation of a two tier arrangement for the return of client money and client assets dependent on the systemic status of the failed investment firm (which appears to be the implication of Paragraph 2.48 of the consultation) would be a welcome development.

2. We doubt whether the personal liability faced by an administrator would typically be amongst the main obstacles delaying progress with an administration but accept that in certain circumstances it could be a factor. Accordingly we would support a limited restriction to the liability of the administrator. Similarly an expedited court procedure could be helpful on occasions – though it would be important to ensure that the process did not get bogged down with overly frequent referrals. As to the proposal to give directors of investment firms greater discretion on the timing of insolvency initiation, we are not sure how practical this would be. We believe that the scope for market facing actions during such a window would be very limited indeed.

3. The Box 2.A example in the consultation paper for a firm that takes deposits and undertakes investment business (a ‘mixed’ firm) considers the interplay between the special administration regime and the banking insolvency procedure – but it does not address the interplay with the SRR as a whole. In fact it is unclear from the consultation paper to what extent the SRR as a whole would apply to a mixed firm, and if so how it would be modified to incorporate the special administration objectives. Further details are awaited. We would comment that it would seem odd for the SRR not to apply to a mixed firm with substantive commercial banking business.

4. On the issue relating to the provision of new funding for a firm in administration, it is presumed that the reference to the measures mooted in ‘Encouraging Company Rescue’ was to the possibility of giving ‘super priority’ to new funds. In responding to that consultation (which was addressed to corporates generally) the BBA argued strongly against the super priority proposals because of the potential impact on other creditors.

5. We have reservations regarding the proposal to establish a resource centre for administrators, given the support that is available from a variety of professional firms. There must also be some doubt as to whether it would be possible to recruit suitable individuals with the necessary current expertise. (Qs 12 and 81)

6. The proposal to allow branches of international banks to opt in to the firm level resolution regime is noted and welcomed in principle – though much would obviously depend on the legal framework and the position adopted by regulators in the relevant jurisdictions. We believe it is unlikely that there would be much take up of opt ins in practice. (Q 13)

7. There are some differences between commercial and non deposit taking investment banks from a resolution perspective – for one thing the need to protect eligible depositors was a key driver for the Banking Act SRR. Nevertheless we believe that serious consideration should be given as to whether the opportunity for pre insolvency formal intervention in the case of a failing investment bank would serve the authorities’ financial stability objectives. (Q 15)

Requiring Firms to Manage for Failure

8. It is recognised that this chapter of the consultation reflects the authorities’ broader agenda for resolution planning. We agree that such planning has a role to play in the

financial reform programme and the industry is engaging constructively in this area. As previously advised we feel the need is to pursue the goals identified by the authorities while at the same time paying full regard to the impact on the competitiveness of the UK financial services industry. The latter cause would obviously be best served by effective international co-ordination of financial reform measures. Also as the consultation paper notes some firms undertaking investment business will be subject to FSA RRP requirements deriving from the Financial Services Bill. Clearly the process needs to be managed to avoid such firms facing duplicative or inconsistent resolution planning regimes.

9. We agree with the policy of requiring investment firms to have a business resolution officer, though we are doubtful about mandating that the person concerned should have to be a member of the firm's board. Some firms might well choose to adopt the latter model in any case but obliging them to do so is judged to be overly prescriptive. It is difficult to estimate likely BRO costs, particularly as the FSA is in the process of moving to a model of more intrusive firm facing supervision but it is quite possible that the costs could be well in excess of the range provided.

10. It is accepted that resolution planning could help to facilitate a managed wind-down of an investment bank's business – though the funding and other pressures on a failing bank could make for a very testing environment. It will be crucial that more is not asked of resolution planning than it can reasonably be expected to deliver – that the temptation is resisted to require plans to be ever more detailed at real cost to the industry's competitiveness. We welcome the commitment in Paragraph 3.23 of the consultation paper that subject to regulatory oversight firms should be allowed to tailor their plans to their own particular circumstances. Also, by their nature resolution plans will contain very sensitive information and the authorities will need to develop mechanisms to ensure that confidentiality is maintained.

11. We agree that business information packs should be a useful resource for administrators and so contribute to the authorities' objectives. Whilst BIPs could not be the complete answer to an administrator's firm knowledge needs the information therein should provide an important 'platform'. We welcome the comments in the consultation paper to the effect that BIPs should be proportionate and that a 'one size fits all' approach would be inappropriate. Adherence to the principle of proportionality will be key if costs are to be kept with in reasonable bounds.

12. We are generally supportive of the authorities' proposals on retention of staff and dealings with suppliers post insolvency. On the latter we believe it would not be appropriate for Government to seek to intervene in contracts, including by seeking to legislate or regulate to require continuity of service. We also support in principle the proposal for an operational reserve – it may be that this could be phased in over a period of time in order to lessen the immediate pressures on firms.

Reconciling and Returning Client Property

13. This is a particularly important topic and we consider that the consultation paper has identified the key issues for review. In some areas the need is to balance the provision of greater security for client assets against possible impacts on industry competitiveness and service levels. We believe that market led initiatives and solutions that leave firms with an element of choice wherever possible may improve the available trade offs.

14. We agree there is scope for providing greater clarity over how shortfalls in client assets omnibus accounts are treated on insolvency through investor education and

greater clarity in documentation. We believe that this is one of the areas in which market led initiatives could make a contribution.

15. We agree too that mandatory warnings on the risk factors arising from rehpothecation and use of omnibus accounts would be helpful. It may be that a series of tailored warnings could be developed at industry level. But we do not think that firms should be obliged to provide designated named accounts at custodians. This should remain a commercial decision for the individual firm.

16. We endorse the proposal that the aim of achieving greater clarity in contractual agreements should be pursued through market led/industry initiatives.

17. Whilst we agree with the broad thrust of the argument on transparency, the scale of the proposed additional reporting requirements in the consultation paper would involve major burdens for firms. We have doubts as to how far these could be justified in terms of the benefits that could flow through to clients. This will be an important area for the full cost-benefit exercise to which the Government is committed.

18. On the proposal to centralise CASS oversight under one individual we recognise the wish of the authorities to augment direct accountability. Equally, however, we are unsure whether a single solution in this area could necessarily accommodate efficiently different firm and group structures. The issues arising may be best addressed in the light of the forthcoming CASS consultation. (Q 42)

19. Whilst recognising the authorities' thinking in the proposal to limit the transfer of assets to jurisdictions where there are interoperability problems with CASS we have significant concerns that the competitiveness of the London market could be undermined and client choice fettered. Depending of the circumstances the clients in question could respond by contracting business directly in the jurisdictions concerned. On the proposal to prohibit the holding of client money with affiliates, we note that this could have major business impacts and wonder if the matter could not be addressed explicitly in negotiations between firms and individual clients.

20. The rational for the proposal that custodians should have to make a statement to the effect that there are no set-off rights/liens over client assets in respect of the firm's own liabilities is understood. Even so we feel that the business implications of such a requirement (especially for clients themselves) should be fully explored. To the extent that the application of the proposed requirement would effectively deny clients access to business opportunities in certain markets it is for consideration whether the clients concerned should have the right to give their express consent to disapplication.

21. We agree with the authorities on the importance of measures to speed up the return of client assets and note that this is the objective of the proposal to set bar dates for client claims. We do have concerns, however, with the risk of disenfranchising those clients who fail to lodge their claims by the due date and careful consideration would need to be given to the length of the bar date period.

Providing Clear and Effective Support for Clients

22. We are unconvinced of the merits of the proposal to establish a client assets trustee in the event of the insolvency of a systemic investment firm. It is recognised that the rationale for the proposal is to facilitate the swifter return of clients' property, most obviously in the case of unencumbered assets, but we wonder whether the proposed

principle of giving precedence to the distribution of client assets together with the other measures in the overall package would have this effect anyway. Moreover administrators currently face difficult issues in managing and balancing the interests of clients and creditors respectively and may be called on to make some hard choices. We have concerns that bringing in a separate insolvency practitioner to act solely on behalf of one constituency could complicate matters, possibly giving rise to material tensions between the two parties and so exacerbating the underlying challenges. It is true that if the two insolvency practitioners were from the same firm then the risk of 'conflict' would be less – not least because the practitioners could hardly help but be mindful of the possible reputational impact on their firm. Whilst in some ways this would be a good thing it could also be considered to create a bias toward compromise. (Qs 52 and 55)

23. We are not convinced that any additional costs of the CAT proposal would be negligible. On the contrary it is considered that the increased complexity of the process and the scope for additional litigation could result in materially higher expenses. (Q 56)

24. As noted we have reservations on establishing client asset trustees – and whilst it would be possible to establish a CAA without taking forward the CAT proposal we have the impression that the authorities view the two proposed initiatives essentially as a package. We are unconvinced as the merits of having an agency or similar body as a centre of expertise on client asset matters – any further review of this idea should give careful consideration to the precise role, status and governance of a CAA. As to the proposal that the CAA should be an 'independent' but integrated part of the FSA we have a number of reservations. In the first place it is difficult to see how a CAA could be 'independent', in the sense of not being subject to the authority of the FSA's senior management and Board. In any case from an overall regulatory perspective it would seem anomalous for one set of regulators at the FSA to be given distinct 'constitutional' status. Furthermore it is not at all clear that the proposed respective roles of a CAA as regulator/supervisor, source of advice/expertise and provider of trustee services would sit well together – it is possible that such a mixed portfolio could obscure clarity of purpose or even lead to conflicts of interest. (Qs 57 and 58)

25. We have doubts on whether an individual from the CAA should be able to perform the CAT role, partly because of potential conflict and liability issues. It is also for consideration whether the proposed regulatory status of a CAA (FSA) employed CAT would put the administrator at a 'disadvantage' in the course of their mutual engagement.

26. We are also doubtful about the CAA (FSA) having powers to sit on creditor/client assets committees – at most it should have observer status. We do not support the proposal for the CAA to have voting rights. (Q59)

Reconciling Counterparty Positions

27. We agree that the issue of incorrect TSO flagging needs to be addressed and support the detailed comments in the AFME response to the consultation. (Q 63)

28. We would be in favour of extending protections similar to those of Part 7 of the Companies Act 1989 to multilateral trading facilities where appropriate and note that the need would be to achieve a consistent application of a set of default rules or default terms across the market/asset class concerned.

29. We welcome the AFME market led initiative for cash equity trades not covered by default rules or default terms of business. We support the AFME position that the protocol should not be placed on a regulatory footing – with the authorities maintaining a watching brief. Regarding valuation methodology it is our understanding that there is considerable market support for a net valuation mechanism. (Q66)

30. As regards the provision of account types for clearing purposes it is considered that the range of account types to be offered is a matter for individual firms to decide on the basis of their commercial judgement. Clients should have sufficient information at their disposal to make informed choices when selecting an investment firm.

Managing Complex Creditor Positions

31. We have seen the ISDA comments on Chapter 7 of the consultation and would endorse these – though we remain unconvinced on the resource centre proposal. Certainly we would favour market solutions with respect to the issue of terminating derivative contracts and valuation disputes.

32. We acknowledge that there were difficulties in the repo market during the financial crisis, in relation to markets and valuation of collateral. It is also acknowledged that so far there is no clear solution to them. However, we would point out that the issue of valuation is not limited to the repo market and for the sake of consistency has to be considered in a wider context. The debate has been ongoing amongst accounting standards setters and regulators as well as firms and some progress is being made. We would welcome a consistent approach to this difficult issue.

Working Towards Cross Border Resolution

33. We recognise that the cross border dimension to resolution can bring material added complexity and note the various initiatives that are being progressed to address the issues arising. We look forward to continuing close liaison between the authorities and industry bodies.

Concluding Remarks

34. We believe that the consultation has done much to advance the debate triggered by the failure of Lehmans and its aftermath. It has also, helpfully, focussed attention on a number of important underlying market issues. As this work goes forward the importance of coordination with the broader financial reform agenda may again be emphasised. This is partly a question of ensuring that the system wide measures to be introduced by the UK authorities are fully 'joined up'. Equally crucial will be that the door remains open to international solutions that may emerge from global policy initiatives.

March 2010

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RESPONSES TO SPECIFIC QUESTIONS IN THE CONSULTATION

CHAPTER 1 - INTRODUCTION

Question 1

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

We do have some concerns on the breath of the definition of investment firms proposed (as per that in MiFID). It will be important that the authorities deliver on the undertaking for the proposals ' to be applied proportionately and to avoid placing undue burdens on smaller firms'.

CHAPTER 2 – ENABLING AN ORDERLY RESOLUTION

Question 2

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

We broadly agree with the proposed objectives for the special administration regime.

The second objective includes a provision that the administrator would provide services and facilities to businesses transferred in the run up to insolvency. Presumably if an investment firm had sold a business to another party prior to insolvency without making any undertaking as to the provision of services this would not apply.

Paragraph 2.20 of the consultation gives the clear impression that the distribution of client assets would have precedence over winding up in the best interests of creditors as a whole. However Paragraph 2.21 says that the SAOs <u>may</u> replicate the type of provision in section 99 of the Banking Act – which obliges the bank liquidator to prioritise the transfer or repayment of eligible bank deposits over the interests of creditors generally. Does this mean that the authorities might apply the principles of precedence to client assets in a different manner to the Banking Act procedure?

Question 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?

Please see Paragraph 2 of our response.

Question 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 when into insolvency.

We think protection should flow from the administrator being able to show that his actions were in pursuit of the SAOs. We do not see that there is any logical linkage between the liability of directors and that of administrators, who perform different roles.

Question 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*?*

As expedited court process along the lines proposed could be helpful on occasions though overly frequent resort to the court should be avoided.

Question 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?

Please see our response to Question 4.

Question 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 financial stability? What specific modifications could the Government consider applying?

Please see Paragraph 2 of our response.

Question 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 described in Box 2A?

The proposed conditions for the initiation of the SAR are endorsed though we do not favour a two tier system for the return of client assets.

It is noted that the interaction between the Banking Act provisions and the special administration regime for firms conducting both investment and deposit taking business will be discussed in more detail in the next consultation paper. It is presumed that the solutions to be proposed will pay due regard to the challenges presented by failing firms with different balances in their operations as between commercial banking and investment business. It is noted that the box 2.A example in the consultation paper considers only the interplay between the BIP and the SAR but presumably in the case of at least some 'mixed firms' the SRR would apply more generally. So for example in the case described in box 2A it is possible that the interests of eligible depositors would have been safeguarded before insolvency proceedings were started. We look forward to seeing further details.

Question 9

Is there a case for considering 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?

Please see Paragraph 4 of our response.

Question 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

We consider that it is too early to conclude that the costs to market participants of implementing a special administration regime would be negligible.

Question 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.

We welcome the Government's commitment to developing effective communications plans and generally agree with the suggestions put forward for communications after the demise of an investment firm. Whilst it is accepted that there will be limits to what may be disclosed the provision of timely information to market participants could make an important contribution following the failure of an investment bank.

Question 12

The Government considers the costs to market participants of a resource centre providing best practice guidance to administrators, and plans for coordinated 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

We are uncertain as to the benefits of a resource centre for administrators when professional accounting firms provide this service as part of their business.

Question 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?

There is merit in principle in this approach but much would obviously depend on the legal framework and the position taken by regulators in other jurisdictions. We believe that it is unlikely that opt ins would generally be taken up by firms given the absence of cross border recognition of insolvency proceedings for investment firms. This highlights the importance of reaching agreement on international recognition of resolution regimes.

Question 14

Are there any other specific issues in relation to cross-border investment firms, not considered here or in Chapter 8, that need to be addressed?

As has been well rehearsed (for example in the recent Basel consultation) enhanced international cooperation between regulators and resolution authorities has a central role to play. In this regard the development of a system for the mutual recognition of resolution and insolvency proceedings for cross border firms would obviously be a major step forward. In the absence of progress in this area the greater the risk of retreat towards 'national' solutions racking up major additional costs for the industry and thus for its customers.

Question 15

The Government welcomes views on the extent to which the package of measures proposed in Chapters 2 and 3 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?

As noted in or response to Question 8 the consultation paper does not make clear whether it is intended that the Banking Act SRR generally would apply to (at least some) 'mixed firms' – though it would seem fairly odd for firms with substantial commercial banking business to be outside the scope of the SRR.

As to the case for having an SRR for (non deposit taking) investment firms, we believe that this merits serious consideration.

CHAPTER 3 – REQUIRING FIRMS TO MANAGE FOR FAILURE

Question 16

Do you have views on the coverage or detail of the BRO's responsibilities as outlined here? Are these consistent or compatible with existing templates for the corporate governance structure of firms?

We agree with the proposed coverage of the BRO's responsibilities.

Question 17

Do you agree with the basic policy of establishing a role for business resolution officers 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?

The case for firms having to appoint a BRO is accepted. Whilst we understand the Government's thinking we are less convinced that the individual concerned should have to be a board member. It would be more efficient in our view to allow for the BRO to be a member of the firm's senior management and for resolution plans to be reviewed and approved, and for accountability to remain, at board level.

Question 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?

If the BRO did have to be a board member then this is the sort of arrangement to be expected – though the significant responsibilities falling to the BRO could lead to the individuals concerned having to cede some of their other responsibilities. It is felt that the authorities need to avoid being overly prescriptive in this area. We are of the view that the BRO's role should be one of coordination in respect of resolution planning but this should not be a substitute for the responsibility of the board and senior management in all times ahead of insolvency. Therefore sanctions for failure should apply at the firm level, not the BRO level, for consistency with accountability.

Question 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

On the basis of what is proposed we think that cost estimates provided may be on the low side. Much would depend on the intensity of the dialogue between the BRO and the FSA but we can foresee scenarios where costs could materially exceed the range given.

Question 20

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

We would comment that even some internal actions could inadvertently tip off the market as to the financial difficulties of an investment firm.

Question 21

What are the obstacles to implementing investment firm resolution plans as suggested in this paper? What policies could the Government consider to address these, if any?

Funding would be the main difficulty. Even before insolvency other market participants could get wind of the firm's problems. A further potential problem for implementation is that when drawing up resolution plans a firm would not have knowledge of market conditions at the time when such plans had to be implemented – obviously the more testing the market environment at the time (in extremis of a fully blown systemic crisis) the more challenging the task would be. Further problems would be likely to arise for cross border firms. Also a very real risk would be that implementation of resolution planning could leak thus leading to a loss of market support.

Question 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 outlined here, do you agree with the suggested costs for the prime brokerage business?

It is very difficult to estimate the costing of resolution planning in advance. As the consultation paper notes, this would depend critically on exactly what was expected of firms.

Question 23

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

As above

Question 24

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

Business information packs should be a useful resource for administrators and so make a contribution to the Government's objectives for a managed wind down of a failing investment bank – though it would be important that BIPs were not viewed as a panacea for administrators' firm knowledge needs. We welcome the recognition in the consultation paper that effort devoted to preparation of BIPs should be proportionate and that a 'one size fits all' approach must be avoided.

Question 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.

As in the case of resolution plans, there may be ongoing benefits to the investment banking business from having in place continually updated BIPs, but these are not included here.

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

We have no evidence to question the cost estimates provided. Experience suggests, however, that without a clear commitment to proportionality costs could escalate quite rapidly beyond the ranges shown.

Question 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.

As above.

Question 27

The Government would welcome views on what incentives and disincentives are likely to be effective and whether there are any concerns with the ones suggested above.

The broad approach of including retention of services clauses in the event of insolvency in relevant staff contracts is endorsed. However the limited post administration working period envisaged could blunt the effectiveness of pecuniary incentives.

Question 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?

The key staff positions identified would seem to be the most important, but we endorse an approach which would enable a firm to nominate its own key roles, this ensuring a comprehensive list and reflecting the industry reality that every firm is structured and managed differently.

Question 29

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

Presumably post insolvency fees for services would be negotiated with suppliers before the bank got into difficulties as a contingency – which could help to avoid the bank being 'held to ransom'. Even so it is quite possible that service providers would be looking for enhanced remuneration in the insolvency period – but it would not be appropriate for the Government to seek to intervene in the process.

Question 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 renegotiating 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. The cost implications of associated policy measures such as an operational reserve for the payment of staff and essential services, the BIPs and BRO are examined in the relevant policy sections.

Do you agree with the cost estimates suggested above, for contractual provisions for key staff and suppliers? What are your views on the incremental costs of: (i) renegotiating 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?

We have no evidence to question the cost estimates provided.

Question 31

What alternative policy tools 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?

We have no further comments other than to strongly endorse the arguments presented against mandating the on-shoring of systems and services.

Question 32

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

We recognise the case for ring fencing operational reserve funds.

Question 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 the suggested cost estimates above? 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?

We have no evidence to question the cost estimates provided.

Question 34

Do you have any views about the operational reserve proposed in Chapter 3?

Please see our response to Question 32.

CHAPTER 4 – RECONCILING AND RETURNING CLIENT PROPERTY

Question 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?

The recent decision by the High Court in London (by the Justice Briggs on 15th December 2009) provided some 'underpinning' for the pro rata principle where there is a shortfall in a client assist omnibus account and the publicity surrounding that decision has been helpful in raising awareness. Nevertheless, it is for consideration whether awareness needs to be heightened further through investor education initiatives and/or greater clarity in documentation and industry bodies could have a role to play in this. No doubt the pending FSA consultation on the CASS regime will address this.

Question 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?

Allowing rehypothecation and using omnibus accounts raise distinct risk factors but we agree that mandatory warnings would be helpful in both cases. However we do not agree that firms should be required to offer clients designated named accounts at custodians. If a firm considers that it is not economic to provide such a facility then it should not be obliged to do so. Investors are free to take their business elsewhere.

Question 37

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

We support the proposal in principle and believe that an industry led initiative may be the best way forward.

Question 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.

We believe that the costs could be much higher than estimates provided, certainly if the risk warnings had to be tailored by product and market. We would support the development of appropriate warnings at industry level.

Question 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?

We have concerns at the breadth of the scope, and frequency, of the proposed additional reporting requirements in terms of the costs likely to be involved. Also we are not sure we fully understand the proposed practical arrangements envisaged for information to be communicated to clients and would welcome further clarification.

Question 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?

Please see our response to Question 39. We would comment further that our understanding is that it is already industry practice for firms to maintain records of both settlement date and trade date information on custody systems.

Question 41

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

Regulated firms holding client money already submit external auditors' reports to the FSA. We would support and industry led initiative to identify what further audited information could usefully be provided to clients in the interests of transparency.

Question 42

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

Please see Paragraph 18 of our response.

Question 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.

We have no evidence to question the cost estimates provided.

Question 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?

The establishment of bankruptcy remote vehicles is an example of firms responding to perceived client preference and as such it is to be welcomed. We are not sure that regulatory or legislative support is currently required but if the authorities have specific ideas in this area these would be of interest. We believe it is a healthy sign that individual firms are pursing particular structures based on their own circumstances ad those of their clients and that prescription should be avoided.

Question 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?

We fear that limiting the transfer of assets to jurisdictions where there are potential interoperability issues with CASS could harm London's competitiveness. In some cases the clients concerned could respond by contracting business directly in the jurisdictions in question. As to prohibiting the holding of client money with affiliates, in some circumstances this could lead to monies being placed with less creditworthy institutions. Please also see Paragraph 19 of our response.

Question 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?

Please see Paragraph 20 of our response.

Question 47

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

We recognise the rationale for the proposal but have concerns that it would further complicate the client money regime.

Question 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 submit a claim by a bar date? Should the Government impose a legal duty on an administrator or trustee to impose a bar date?

This is a difficult issue because it involves balancing the desirability of expediting the return of property to the rightful owners against the risk of disenfranchising a minority of clients. Please see Paragraph 21 of our response.

Question 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 over liens. Additionally there could be other 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; and***

- ***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.

Members have indicated that some of the cost estimates appear to be on the low side (e.g. for dividing client money into separate pools). More importantly the cost figures given do not take account of the ongoing impact on firms and their customers. For example if custodians could not rely on set-off rights/liens they would need to protect their positions at the expense of firms in other ways, affecting pricing and possibly market access for clients. Also we have received feedback indicating that restrictions on the transfer of client money to affiliates could have a broader impact of firms' ability to provide a global service to clients.

Question 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 'futureproof' and do they have a limited negative impact?

We welcome the recognition of the need for flexibility but have nothing specific to add at this stage. Please see Paragraph 13 of our response.

Question 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?

Not at this time.

CHAPER 5 – PROVIDING CLEAR AND EFFECTIVE SUPPORT FOR CLIENTS

Questions 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?

Please see Paragraph 22 of our response.

Question 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?

Please see Paragraph 22 of our response. If the trustee proposal was to be taken forward we would suggest that the legal procedure should be as under existing administration law with client assets remaining vested in the company.

Question 54

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

If the proposal was to be taken forward then it would seem logical for the associated costs to be funded out of client assets.

Question 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?

Please see Paragraph 22 of our response.

Question 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.

Please see Paragraph 23 of our response.

Question 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?

Please see Paragraph 24 of our response.

Questions 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?

Please see Paragraph 24 of our response..

Question 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?

Please see Paragraph 26 of our Response.

Questions 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?

If these proposals were to be taken forward we think that all investment firms holding client assets would have to fall within the jurisdiction of the CAA – but we do not support the proposals.

Question 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?

From a resources/economy perspective what matters is the quantum of resource deployed – not how the department/division is labelled. We think the most important thing is to get the structure right, as per our earlier comments.

Question 62

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

We have no further comments at this stage.

CHAPTER 6 – RECONCILING COUNTERPARTY POSITIONS

Question 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 to address incorrect TSO flagging, 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.

Please see Paragraph 27 of our response.

Question 64

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

As above.

Question 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 for all affected parties, including creditors? What other options should the Government consider?

Please see Paragraph 28 of our response.

Question 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?

Please see Paragraph 29 of our response.

Questions 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?

As above.

Question 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?

As above.

Question 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.

Not that we are aware of.

Question 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?

We suggest that market led initiatives should be given more time to develop.

Question 71

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

No further comments at this stage.

Question 72

Initial 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 also 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.

We have no reason to question the cost estimates provided by stakeholders but it is assumed that these do not include possible post implementation business impacts.

Question 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?

In view of current CCP practice regarding segregated accounts we do not see a pressing need for an explicit requirement.

Question 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?

It is considered that the range of account types provided is a matter for individual firms to decide on the basis of their commercial judgement. Clients should have sufficient information at their disposal to make informed choices when selecting an investment firm.

Question 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.

No further comments at this stage.

Question 76

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

Despite the potential complications identified EUI's proposed approach appears to be the most effective way forward in the circumstances posited.

Question 77

Have the key consequences of EUI's proposal to increase certainty of settlement been identified correctly and do the benefits for the market as a whole of the proposed revised approach outweigh these consequences?

We believe so.

Question 78

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

We would be reluctant to see Government intervention. We believe that market solution is achievable.

Question 79

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

Not applicable.

CHAPTER 7 – MANAGING COMPLEX CREDITOR POSITIONS

Question 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?

Please see Paragraph 31 of our response.

Question 81

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

Please see Paragraph 5 of our response.

Question 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?

This is a difficult issue as it stems from legitimate risk management on the part of market participants. Please see Paragraph 32 of our response.

Questions 83

In relation to the areas listed here, 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?

We have not identified any such factors.

Question 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 here and which the Government should consider?

No further comments at this stage.

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16 March 2010

Submitted by Email

Dear Sirs,

Establishing resolution arrangements for investment banks

We refer to HM Treasury's paper "Establishing resolution arrangements for investment banks" and are pleased to provide the requested comments on the questions which it raises.

We have confirmed our responses to those questions in which we have a particular interest, where we do not comment expressly we can be taken to have approved the points made in the Paper in connection with the question.

Introduction

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

Whilst the different definitions for investment firms are initially confusing it becomes clear as the paper progresses that the distinction between investment firms will be an important one where particular measures are proposed which are aimed at preventing systemic failure and are therefore not necessarily appropriate for smaller enterprises.

Chapter 2 - Enabling an Orderly Resolution

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

We reiterate our views that we do not consider a bespoke administration regime necessary for investment firms. We remain unconvinced that having a separate process with specific objectives will necessarily mean a quicker return to creditors or those who have client assets with the failed firms.

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?

Whilst we appreciate that insolvency practitioners acting as administrators for failed investment banks may welcome proposals to limit their liability in certain circumstances, we do not think that a blanket restriction on liability is necessary or indeed appropriate. The present legislation is sufficient already in the form of administrators being able to seek contractual exclusions for personal liability and at the end of the process by seeking a statutory discharge. In addition similar exclusions do not apply to other special administrations. The promise of exclusions here would therefore seem inconsistent.

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?

We agree that the personal liability of administrators should not be greater than that of company directors before the company went into the formal insolvency process.

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?

Given the fact that the present court system allows for urgent applications to be made we do not think that a bespoke expedited court process is necessary.

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?

We consider that the court's current approach to imposing liability and not interfering with commercial arrangements and decisions entered into by administrators is already sufficient.

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 financial stability? What specific modifications could the Government consider applying?

We do not think it is necessary to provide directors with a special defence against actions taken by administrators in relation to their implementation of resolution under the current regime. Directors are not obliged to file for insolvency immediately, but in order to avoid personal liability arising out of Section 214 Insolvency Act 1986, they already have the benefit of being able to rely upon a satisfactory defence where they can show that they took every step to minimise exposure to creditors.

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 described in Box 2A?

Subject to our reservations about the introduction of the special administration regime we consider that the scope of the regime and its interaction with the provisions of the Banking Act 2009 appear to be appropriate. We would need to consider in further detail the memorandum of understanding that is envisaged between the authorities and therefore we await the draft regulations in this respect.

9. Is there a case for considering 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?

We do not consider that it is necessary to have specific provisions dealing with new financing in the context of investment firms. The administrator of an investment firm can already agree funding and priority on a bilateral basis if and when appropriate.

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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

No comment.

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.

In terms of providing appropriate information for market participants we consider that the timely provision of such information is key, therefore information regarding the status of the ailing investment firm on a publicly available website together with contact details for the insolvency practitioners appointed would be useful.

12. The Government considers the costs to market participants of a resource centre providing best practice guidance to administrators, and plans for coordinated 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

The cost of providing this resource and plans for co-ordinated marketing communication may not be insignificant as a certain amount of maintenance and up keep would be required. It is not clear as to who would fund the resource centre although we understand that it is to operated by the authorities.

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?

The availability of an 'opt in' for international entities does provide and encourage the use of the UK resolution regime, but as to how it would work in practice remains to be seen. It may create a level of uncertainty and it will also be dependent on cooperation from courts/legislation outside the UK.

14. Are there any other specific issues in relation to cross-border investment firms, not considered here or in Chapter 8, that need to be addressed?

Consideration ought to be given in relation to the ability for resolution regimes initiated outside of the UK to be recognised.

15. The Government welcomes views on the extent to which the package of measures proposed in Chapters 2 and 3 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?

We are of the view that early action and prevention of an investment firm failure will undoubtedly provide a better recovery and protect against systemic risk.

Chapter 3 - Requiring firms to manage for failure

16. Do you have views on the coverage or detail of the BRO’s responsibilities as outlined here? Are these consistent or compatible with existing templates for the corporate governance structure of firms?

The BRO's responsibilities appear to be comprehensive but we fear that they may overburden existing CEOs by expecting them to assume such a role in addition to their other responsibilities.

17. Do you agree with the basic policy of establishing a role for business resolution officers 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?

We agree that a business resolution officer may be an effective way of implementing resolution actions. We consider that it may be suitable to combine this function with the existing compliance function within the firm, at director level rather than CEO. We agree that having a board member carrying out the responsibilities of a BRO in conjunction with pre existing duties as being the most effective way of introducing this kind of officer.

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?

See above.

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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

No comment. The costs are subject to a high number of variables which make any accurate calculation difficult to estimate.

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

A resolution plan will be largely determined by the nature and cause of the investment firm's difficulties. The formulaic approach to resolutions set out in the consultation paper will by necessity form part of the management process in any event but will in part dictated by the challenges in any given case.

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

The difficulties in implementing resolution plans suggested in this paper aren't necessarily those which may be resolved by the policies suggested by the government in this paper.

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 outlined here, do you agree with the suggested costs for the prime brokerage business?

No comment.

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

We agree with the list of costs anticipated to the implementation of the resolution plan.

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

We consider that the use of business information packs maybe of limited assistance. The basic information will provide insolvency practitioners with a starting point and initial contact details but that will not replace the requirement for co-operation of those within a failing investment firm.

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.

As in the case of resolution plans, there may be ongoing benefits to the investment banking business from having in place continually updated BIPs, but these are not included here.

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

No comment.

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.

No comment.

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

We consider that the 90 day notice period for the continuation of services and key staff to be a costly insurance policy in the event of failure. In terms of incentives, an administrator can already under the present regime, negotiate incentives with key staff members. The proposed disincentives, for example a claw back relating to the unsatisfactory performance of employees, would in practice be unworkable and would prove to be very costly and time consuming for administrators to pursue and ultimately be an unnecessary drain on the resources of the failed firm.

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?

Key staff have been categorised according to their special areas, we note that the general management is not included in the present list but much will depend upon the particular cause of the failure as to which different individual staff members may be considered key in any given circumstance.

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

We don't believe that the government should interfere with parties ability to contract freely. However we think that it may appropriate to replicate the present system contained within section 233 of the Insolvency Act which does not allow utility suppliers to make future supply conditional upon payment of pre insolvency liabilities.

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 renegotiating 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. The cost implications of associated policy measures such as an operational reserve for the payment of staff and essential services, the BIPs and BRO are examined in the relevant policy sections.

Do you agree with the cost estimates suggested above, for contractual provisions for key staff and suppliers? What are your views on the incremental costs of: (i) renegotiating 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?

We consider the idea of renegotiating existing contracts to lock in staff and supplies unnecessary.

31. What alternative policy tools 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?

We think that administrators should continue to negotiate separately for essential services and key staff continuance. UK firms would if such proposals were implemented suffer from a higher cost base and this may have the impact of them being unable to remain competitive.

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

We consider that ultimately the administrators should be able to use the operational reserve in a manner that they consider appropriate at the time. Allocating funds for particular expenses has the potential to become uncertain as we have seen in the context of administration expenses generally and the ongoing debate in various cases regarding what type of expenses should be included.

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 the suggested cost estimates above? 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?

No comment.

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

We believe that the operational reserve proposed adds to the ultimate cost base of investment firms and therefore could affect their profitability and consequently make them less competitive than non UK counterparts.

Chapter 4 - Reconciling and returning client property

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?

We understand that the FSA are already seeking to address and make clear how short falls in omnibus accounts are to be treated and client entitlement devised.

Much uncertainty would be resolved if legislation can state clearly that where securities[1] are held by a custodian for a number of clients in an omnibus client account which the custodian has opened with a subcustodian or settlement system, the custodian holds the pooled securities on trust for the relevant clients, each of which has a beneficial interest in a proportion of the pooled securities (such proportion to be calculated by reference to the number of securities recorded in the name of each client in the books of the custodian). At present it is arguable that this is the result of holding in an omnibus account, but the legal analysis is based on a sequence of cases, some of which are contradicted by other cases. To eliminate the current uncertainty, this issue should be clarified.

It would be helpful to have clarity that, in the absence of clear evidence to the contrary, shortfalls in omnibus securities accounts should be borne by clients pro rata. However, it would be manifestly unfair if all clients were affected by a shortfall which clearly arose as the result of settlement of a transaction for a particular client. (In contrast, shortfalls in relation to client money accounts are borne by clients pro rata pursuant to the FSA client money rules.)

Determining the "entitlement" of clients to cash and securities held on trust in the event of the insolvency of the custodian is not the same as determining the amount of a contractual claim against the insolvent entity, because the cash and securities held on trust are the property of the client not an amount or asset owed by the custodian. The starting point for determining the assets held on trust for a client will be the latest client asset records of the custodian, but it will also be necessary to take into account any assets received by the custodian after the onset of insolvency on behalf of clients (for example, settlement of purchase transactions, or receipt of distributions).

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?

We agree that warnings in respect of rehypothecation and omnibus accounts may be of assistance in reminding clients of the risks. However we remain of the view that clients should be allowed to assess the risk and approach investments in accordance with their own risk profile.

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[1] cash which is held pursuant to the Financial Services Authority ("FSA") client money rules is held on trust subject to such rules

Mandatory warnings regarding the implications of rehypothecation and use of omnibus client accounts are advisable so that clients are clear regarding the effects of such arrangements. Note - the pre-MiFID CASS rules required custodians to notify all clients if holding securities in an omnibus account, and to give additional explanation of the implications to retail clients; under current FSA rules (Conduct of Business rules not CASS) implementing MiFID, notification and "prominent" warning is required for retail clients only, and extending such requirements could have the result that UK regulatory requirements are more onerous than in other EEA jurisdictions.

In practice, such warnings are of limited efficacy if clients do not focus on them, for example by being required to sign an acknowledgment of the warning (but investment firms are likely to resist such a requirement).

Any such warnings would need to be drafted carefully, to be clear what is meant by an "omnibus" account. For example, reference to a custodian holding client securities in an omnibus account is generally understood to mean that the custodian records the client's securities in a separate account for that client in the books of the custodian, but when the holding of such securities is delegated to a sub-custodian or settlement system, the sub-custodian or settlement system records the relevant securities in its books in an omnibus account in the name of the custodian which is designated as a client account.

Clients sometimes request that their securities are held by the custodian in a separate account opened by the custodian with a subcustodian or settlement system which holds only assets belonging to the client. (This process can be expensive, and is requires more complex administration arrangements.) However, even if the custodian can offer this second level of separate account, omnibus accounts are still likely to be involved in the chain of intermediaries through which the securities are held, since it is likely that the sub-custodian or settlement system in turn holds through an intermediary which holds in an omnibus account. For example, where an issue of securities is deposited into a settlement system, typically all such securities are registered in the name of a nominee for a depositary, and the depositary holds on behalf of the settlement system. The securities held by the settlement for a particular participant (let alone a specific client of that participant) are not identified in the books of the depositary or the nominee.

Also, it is important to be clear as to terminology. "Rehypothecation" and "right of use" are only relevant where the client assets are charged in favour of the investment firm, but the terms of the charge permit the investment firm to (in effect) transfer such assets to itself so that it obtains outright title subject to an obligation to return such assets or the value of such assets (and this is only permitted where the security arrangement is within the scope of the Financial Collateral Regulations (SI 2003/3226), therefore cannot apply where the client is a "non-natural person", for example an individual). This is not the same as a title transfer collateral arrangement, where the investment firm receives transfer of outright title by way of collateral subject to an obligation to return such assets. It should be noted that in the January

2010 "Client Money & Asset Report" of the FSA, the FSA states that it has concerns about the use of title transfer arrangements and will be clarifying the relevant rules which permit such arrangements.

(2) Whether firms offer or provide designated named accounts should be left to the commercial requirements of the clients (for example, it is not unusual for pension funds to request a greater level of designation).

(In any event, a requirement to offer designated named accounts can only refer to designated named accounts in the records of the custodian's delegate; a requirement to offer designated accounts at all levels in a chain of intermediaries would be unworkable.)

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

We consider that there is already a heightened market awareness on the contractual arrangements. These have been recently highlighted by the failure of Lehman Brothers, but we do not consider this is an area that requires intervention by the Government.

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:

(i) warnings on rehypothecation; and

(ii) 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.

No comment.

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?

We do not consider that increased reporting would have assisted in the failure of Lehman Brothers International Europe. In the short time that was available before its ultimate demise there was nothing that could have realistically been done or prevented by virtue of having a reporting requirement.

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?

We agree that having increased record keeping requirements for investment firms may be useful for the purposes of reconciliation, we do not consider that it will prevent failure.

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

We consider there to be limited value in increased audited disclosures since they will become very dated in a very short space of time.

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

It may be a useful and cost effective exercise to centralised CASS and FSA CF-29 under one individual.

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;

(i) 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

(ii) 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.

No comment.

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?

We consider that the market lead solution should continue, but we do not consider it necessary for the Government formal support which may complicate the process and increase the costs.

If client assets held in omnibus accounts by custodians are clearly ringfenced on the insolvency of the custodian (see answer to question 35 above), it is not clear what additional benefit is provided by a bankruptcy remote vehicle, unless it is possible to ringfence the personnel and systems operating the vehicle so that the vehicle can continue to operate despite the insolvency of the custodian but this seems unlikely as discussed below.

Client assets must remain on the balance sheet of the clients, therefore under English law the vehicle must either (a) hold the assets on trust for the clients, or (b) hold the assets on trust for the custodian which in turn holds on trust for clients. In (b), the vehicle is a subcustodian of the custodian and the usual issues arise on the insolvency of the custodian.

If the vehicle holds assets on trust for the clients, practical issues will still arise on the insolvency of the custodian. For example, it is likely to be the custodian's systems and employees which control movements of securities, and maintain relevant records. It is unlikely that such processes will continue without delay if the custodian is insolvent. Also, as a practical matter, in most cases the vehicle would need to delegate the holding of the securities to a global network of subcustodian and settlement systems. This may cause issues with documentation and ongoing operations since settlement systems and subcustodians will be more familiar with dealing with participants with existing systems and expertise of sufficient size. There may also be difficulties with arranging credit lines for settlement arrangements. Tripartite arrangements involving the custodian, the vehicle and the sub-custodian/settlement firm may be possible (i.e. whereby the custodian accepts liability for the vehicle), the documentation process will be complicated, this may not be possible in all cases, and this does not resolve the question of who is able to access records, and control the transfer of securities to or from the vehicle, where the custodian is insolvent.

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?

We do not consider that it is appropriate for the Government to impose limits on the transfer of client money to affiliates and jurisdictions, but clients should be made aware of the added risk of intra-group transfers or accessibility to client money in the event of failure so that they can take an informed approach to such risk.

The FSA client money rules already incorporate the requirements of the MiFID implementing directive regarding the types of entity with which client money may be held, in particular permitting holding only with a central bank, a BCD credit institution, a bank authorised in a third country or a "qualifying money market fund" (as defined in the MiFID implementing directive). In addition the rules incorporate the directive requirements that a firm must "exercise all due skill, care and diligence in the selection, appointment and periodic review" of the relevant credit institution, bank or money market fund and "the arrangements for the holding of this money", and in doing so must "take into account: (1) the expertise and market reputation of the third party; and (2) any legal requirements or market practices related to the holding of client money that could adversely affect clients' rights".

It is not clear that any further restrictions would be consistent with the MiFID implementing directive.

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

In practice, there is no need to impose such a requirement since the FSA Conduct of Business rules require custodians to disclose to clients any lien or set-off rights which they or their delegates have in respect of client assets, and the custodian client can then decide the extent to which such terms are acceptable.

The statement in 4.72 is inaccurate in stating that the acknowledgment required by the FSA client money rules from banks in relation to client money "confirms that the bank … has no lien or right of retention over the account and that it will not seek to combine, net or set off the account against the debts or obligations of the firm." The acknowledgement must include confirmation that "the bank is not entitled to combine the account with any other account to exercise any right of set-off or counterclaim against money in that account in respect of any sum owed to it [the bank] on any other account of the firm" (emphasis added). In effect, set-off rights over a client money account are permitted in relation to amounts owed in respect of that account.

This is a significant point since a custodian must as a minimum be permitted to have rights of lien and power of sale over securities (even if client assets) where the custodian has advanced the funds to purchase such securities (a common occurrence given the timing issues which arise in settlement processes, particular in cross-border arrangements involving transfers of securities and cash in different time-zones).

Furthermore, the client money acknowledgement only limits the rights of the bank which owes the money to the firm holding such money as client money. It does not consider the rights of any delegate of the bank since the holding of cash as banker does not involve delegation of holding of the cash by the bank. In contrast, where a custodian holds securities, it is inevitable (except in some highly specialised arrangements) that the custodian will be holding the relevant securities through a network of subcustodians and settlement systems, each of which will have lien rights in its standard terms and there may be limited ability to remove such rights. As a result, even if a custodian may agree to exercise no rights over client securities, it may be unable to ensure there are no other rights of any type over the relevant securities.

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

This may prove a useful and practical alternative to managing risk associated with client money.

The costs and administrative complexity of such an approach would need to be considered carefully.

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?

We do not think that it would be helpful for there to be a legal duty on administrators or trustees to impose a bar date. There is already sufficient flexibility within the existing system that allows administrators to seek the court's direction to impose a bar date for specific cases.

Imposing a bar date after which property rights are extinguished would be a radical solution because arguably there is no other provision of English law which removes property rights as a result of the lapse of time or failure to claim. It is important to remember that a client's right to cash and securities held on trust is not the same as a contractual claim against the insolvent entity; the cash and securities held on trust are the property of the client not an amount or asset owed by the custodian.

A compromise may be to set a date for the submission of notification of trust rights on the basis that notifications received by the relevant date will be dealt with first, and that later notifications do not lose their trust rights but will still be entitled to redelivery of their assets to the extent available and otherwise will have tracing rights in the usual way.

49. Our initial discussions with stakeholders indicate that:

(i) 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;

(ii) 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 over liens. Additionally there could be other 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;

(iii) 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; and

(iv) 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.

It is not a negligible cost if as a result of missing the bar date a client loses its trust assets. 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 ‘futureproof’ and do they have a limited negative impact?

We consider that some of the suggested proposals for the treatment of client money are too onerous and may undermine commercial liability of such business. Some of the risk should be borne by the investors who are sophisticated parties often with the benefit of professional advice.

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

We consider that the process of identification and reconciliation is key for improving the return of client money and assets. This may be effectively achieved by closer monitoring and supervision.

See comments above regarding risk of conflict with MiFID regulatory regime, and situations where it is arguably preferable to leave the issues to be agreed on a commercial basis by the relevant parties.

Chapter 5 - Providing clear and effective support For clients

51. 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?

We are not in agreement that there is a need for a CAT in practice as the administration of LBIE has demonstrated different teams within the administrator's firm will focus on different activities so as to ensure an efficient return of client assets.

Subject to the need for some clarification of the FSA client money rules, the main requirement is not for additional or different rules but better monitoring and enforcement of compliance with the rules which currently exist.

52. 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?

Although it may be an advantage to impose fiduciary obligations of the trustee and the CAT we consider that the simple approach would be to have the CAT controlling the assets.

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

We consider that the beneficiaries of the client money and assets should fund the CAT.

54. 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?

We do not consider it necessary to have an amendment to the duties of administrators to expedite the return of client money and assets.

55. 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.

We do not consider that this would be negligible as there may be issues and in particular disputes about ownership of assets.

56. 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?

Given the fact that any administrator is an officer of the court we do not consider that an individual from the CAA should be necessary and will just add cost to the process.

57. 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?

Whilst the establishment of the CAA may be useful do not consider it a necessity . In the event of that CAA is established then we think that this could be combined with the role of the FSA.

58. 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?

We do not consider such powers to be necessary or required and do not consider it appropriate to include a right to vote.

59. 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?

Yes, see comments about the effectiveness of a CAA.

60. 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?

No comment.

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

We do not consider that the establishment of the CAT or CAA is necessary and supervision of clients adherence to client money should already be catered for and under the existing suspension conducted by the FSA.

Chapter 6 - Reconciling counterparty positions

62. 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 to address incorrect TSO flagging, 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.

No comment.

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

No comment.

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

No comment.

65. 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?

No comment.

66. 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?

No comment.

67. 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?

No comment.

68. 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.

No comment.

69. 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?

No comment.

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

No comment.

71. Initial 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 also 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.

No comment.

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

No comment.

73. 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?

No comment.

74. 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.

No comment.

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

No comment.

76. Have the key consequences of EUI's proposal to increase certainty of settlement been identified correctly and do the benefits for the market as a whole of the proposed revised approach outweigh these consequences?

The proposed approach is extremely odd, and it is not clear that this is consistent with EUI's status as a designated system for settlement finality purposes. Since EUI is a designated system for the purposes of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (SI 1999/2979), under Article 14 of such Regulations, a transfer order shall not "be regarded as to any extent invalid at law on the ground of inconsistency with the law relating to the distribution of the assets of a person on bankruptcy, winding up, administration, sequestration or under a protected trust deed, or in the administration of an insolvent estate". Chapter 13 of the EUI Rules includes the following statements: " A participant or any third party (including without limitation any liquidator or other insolvency office-holder of a participant or a receiver other than an administrative receiver) shall not revoke, or purport or attempt to revoke, any transfer order from the time at which it becomes irrevocable" and " A transfer order shall be irrevocable from the time at which the order of the relevant transaction type is or becomes incapable of being amended or deleted in accordance with the procedures of the CREST UK and Irish system for the time being (which are explained in the CREST Manual) by the single input of an instruction from the participant who wishes to amend or delete the order." It is also noted in this Chapter that these provisions do not "require or permit the settlement of a transfer order in respect of a market or other contract which has been discharged under the default rules or similar rules of an investment exchange, clearing house or multilateral trading facility."

The major problem which arose on the insolvency of Lehmans was the fact that many transactions pending settlement could no longer be deleted from the system by one party unilaterally, and should therefore under EUI's own rules have proceed to settle despite Lehmans' insolvency, except to the extent otherwise dealt with under relevant default rules of exchanges, clearing houses or MTFs. It is not clear why EUI did not follow its own Rules in relation to pending settlements involving Lehmans, and arguably if it had done, the confusion which resulted from the delay in deciding how to proceed would have been significantly reduced. It is therefore argued that the proposed approach of cancelling all pending settlement instructions is incorrect. For any settlement instructions which cannot be deleted by one party unilaterally, EUI should comply with the intention of the settlement finality directive by allowing such settlement instructions to proceed to settle.

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

An important related point arises from the way in which the Settlement Finality Regulations (SI 1999/2979) implement the Settlement Finality Directive (Directive 98/26/EC). Because of the narrow way in which "collateral security" is defined in the Regulations, where an EUI participant has granted a security interest over securities held in EUI to another EUI participant, the security taker is unlikely to be able to access the securities in the event of the security giver unless the security taker is an EUI settlement bank. This is a significant problem for commercial counterparties wishing to make use of securities held in EUI as collateral, and leads to increased uncertainty and difficulties in the event of insolvencies. It is strongly recommend that the Regulations should be amended to clarify that the term "collateral security" also includes securities held in a designated system which a charged by any system participant in favour of another system participant.

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

Chapter 7 – Managing complex creditor positions

79. 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?

No comment.

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

This may be useful but limited resource and will have attendant costs in setting it up and maintaining the centre so that it is up to date.

81. 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?

No comment.

82. In relation to the areas listed here, 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?

No comment.

83. 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 here and which the Government should consider?

No comment.

Annex C – Consultation Stage Impact Assessment

84. Do you have any suggestions which could help improve the Government's proposed quantification strategy? If so, please specify what these are.

No comment.

85. Are you able to provide an estimate of the financial impact of any delays or issues with LBIE's resolution process on your firm, as a counterparty, client and/ or creditor? If so, please provide an estimate for losses in the areas below, and what caused them. Please give the Government an idea of your firm's size.

(i) For counterparties, please provide any information about the cost to your firm of uncertainty about what would happen to trades at trading, clearing and settlement, inability to hedge exposures, and the need to double-margin.

(ii) For clients, please provide any information on resources allocated to sorting out an investment bank failure, and any cost from inability to use capital and assets tied up in the investment firm.

(iii) For unsecured creditors, please provide any information about losses caused by destruction of the intrinsic value of the firm's estate as a result of events occurring after the administration.

No comment.

86. Are you able to provide any information which might help the Government quantify the ongoing or broader 'ripple' impacts of issues with the resolution process of a failing investment firm as described above? If so, please provide an estimate.

No comment.

87. Are you able to provide any information that would help the Government to assess the loss of confidence caused by any problems with the resolution process itself, as described above? If so, could you please provide an estimate of costs associated with the loss of confidence?

No comment.

88. By what percentage do you believe the proposals in this document might reduce any issues associated with the resolution process for an investment firm? Do you agree that, as a minimum, the overall package of measures proposed has potential to reduce any difficulties by 50%?

No comment.

Yours faithfully

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Response of Financial Law Committee of the City of London Law Society on HM Treasury Paper – Establishing resolution arrangements for investment banks (December 2009)

INTRODUCTION AND EXECUTIVE SUMMARY

1. The City of London Law Society ("CLLS") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

2. The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the Consultation Paper has been prepared by the CLLS Financial Law Committee and members of its working party are listed at the end of this response. We should be happy to discuss any issues if this would be helpful.

3. We are grateful for the opportunity to respond to the Consultation Paper and for the extra time afforded for this response. We have had the opportunity to read the response of the CLLS Insolvency Law Committee covering the matters raised in Chapters 2, 5 and 8 of the Consultation Paper, and the response of the Regulatory Law Committee covering in particular the matters raised in Chapter 3 and the regulatory issues in Chapter 5 of the Consultation Paper. Our comments are therefore primarily directed to the other sections of the Consultation Paper.

4. There are in all three submissions from CLLS Committees expressions of concern about an over-heavy reaction to the recent crisis and the failure of Lehman, which risks imposing very heavy burdens on market participants. There are a large number of other complex regulatory measures in the pipeline. We urge that a "proportionality" review is carried out before introducing measures, particularly those of a regulatory nature, to ensure that they do not impose undue or unnecessary burdens or cause confusion and that they do not un-necessarily affect competitiveness of firms in the market place or curtail access to the market.

5. Importantly, we consider that many of the issues addressed are not unique to investment banks. The issues relevant to the Lehmann insolvency are in many cases a result of the factual situation and only to a limited extent capable of improvement through a legislative means. Of these a special insolvency process appears less important than addressing the confusion that the courts have found in the FSA rules and in ensuring that record keeping requirements are appropriate.

6. One of the key benefits of the English legal system, which we believe is shared by its general insolvency laws, is the flexibility of those systems to deal with difficult and changing situations. We recommend therefore that care is taken not to disturb that flexibility.

7. We note that the CLLS Insolvency Law Committee considers that a strong case needs to be made before any new insolvency procedure or modified insolvency procedure is introduced. There are now over 20 "special" insolvency procedures in the UK. For the reasons stated by that Committee we very much support a "light touch" approach to any modifications to the existing administration regime for an insolvent investment firm. We consider, however, that the proposed special objectives would provide clarity and transparency both for the administrator and the counterparties as a variation of the standard objectives in an administration and would support their introduction in the case of administration of an investment bank (or indeed more generally for businesses holding third party assets). This might be better done by amendment to the Insolvency Act than by creating a special regime. As regards the proposals for a bar date for client asset and client money claims, we are strongly of the view that these would be a useful

modification to the insolvency legislation, but applicable in all cases where third party assets are held by an insolvent business, not just investment banks, and should operate to bar proprietary claims not only against the company and its administrator/liquidator, but also against any third party to whom assets are distributed.

8. We also agree with the views of the Insolvency Law Committee that, rather than lowering the standard of care for an administrator's duties (or attempting to come up with an alternative formulation for the standard of care), an administrator will be sufficiently protected if his duties are linked to the pursuit of the special objectives.

9. We, like the Insolvency Law Committee and the Regulatory Law Committee, are very concerned about the proposals in Chapter 5 of the Consultation Paper and, in particular, the proposals for the appointment of the Client Asset Trustee (**CAT**). We consider that these proposals are likely to add to the cost and complexity of the administration without giving rise to any real benefit. To have separate officeholders appointed in respect of the client assets and the general estate would inevitably lead to duplication and potentially litigation regarding the respective roles. We strongly urge the abandonment of these proposals.

10. On the cross-border side, we believe that there is no easy answer to the cross-border issues and ultimately we suspect that the UK Government can only legislate for UK firms while monitoring closely the international developments referred to in Chapter 8 to ensure that the UK proposals are not inconsistent with these developments, as well as participate in international discussions to seek to achieve maximum harmonisation, whether at EU level or through other international treaties.

CHAPTER 1

The aims discussed in the Consultation Paper are worthy. We would make only 3 points:

- HMG should guard against the temptation to have an over-elaborate response, which would impose unnecessary burdens on investment businesses and potentially damage the reputation of London as a place to do business;

- A number of the matters dealt with in this paper are matters where the EU and G20 initiatives may also apply. It is particularly important to ensure that UK legislation meshes well with EU legislation: a good example is the proposed definition of "investment bank" (on which our views are sought in **Question 1**), which is unexceptional, but, if the EU were to adopt a different approach to that in Conditions 1 and 2, then the UK approach should be aligned rather than a different definition maintained. It is therefore important that HMG engages fully in the EU legislative process and that legislation allows for amendment to achieve alignment. This assumes that the EU approach leaves the relevant areas of legislation with Member States and greater adjustment and review would be needed if measures such as living wills were regulated by a European body;
- Issues arising in the collapse of Lehman were inevitably complex, given the size and complexity of the failed business. We discuss this in detail in response to Chapter 4. It is inevitable that in such large insolvencies, resolution cannot be achieved overnight and it is important to disentangle those issues which can be addressed from those which cannot. It should also be noted that issues related to third party assets can arise in any business that holds such assets, not only investment banks. There is therefore a case for recognising this through changes to general insolvency law rather than mechanisms limited to "investment banks" as defined.

CHAPTER 2

We are in broad agreement with the views of the Insolvency Law Committee's response to this Chapter and would refer you to that response.

CHAPTER 3

We endorse the views of the Regulatory Law Committee in response to this Chapter.

We will not therefore comment on these, save to say that there needs to be a proper balance of resources between banks updating substantial plans for a relatively rare event and the conduct of day to day business, so that it would be more efficient if methodologies of record keeping that are relevant to day to day business can be utilised to provide the underlying data for a "living will", since this would be less costly and provide better incentives for investment firms to continue to do business in London than complex and expensive separate systems. As we remark in our comments on Chapter 4, we consider that it is inevitable that a business in steep financial decline is likely to let aspects of its affairs slide and the more separate the processes required, the more likely that they will be neglected.

CHAPTER 4

1 General comments

HM Treasury states at paragraph 4.2 of the Consultation Paper that the key issue for the Government is to ensure that the legitimate and reasonable expectations of clients for the protection and return of money and assets are met in a manner that allows for the maintenance of a flexible and competitive market for investment business.

By this we assume that HM Treasury recognises that there is a need for a balance between the legal and practical protections that can be given to clients' assets and monies against a firm's insolvency, and the cost and burden that those protections inevitably bring. There is little advantage in designing and implementing a system of protections if those protections are too expensive in practice and damage the competitive position of the UK.

It is also crucial to bear in mind that many of the difficulties arising in relation to the return of client assets and money in the Lehman insolvency were the product of practical issues, as HM Treasury describes at paragraph 4.6 of the Consultation Paper. While many such problems can be resolved through changes in regulation and changes to how investment banks are 'resolved', there is no quick and ready solution to guaranteeing the speedy return of all of a client's assets and money in the event of insolvency. In the imperfect and highly complex world in which investment banks operate, it is as much the responsibility of clients to recognise and manage that risk, as it is the responsibility of the investment banks and regulators to try to ensure that material risks do not arise. Again, that is another balance that we believe the Government needs to be careful to strike.

Finally, we note that the Government believes that the underlying existing protections for client money and assets are generally fit for purpose (see paragraph 4.23 of the Consultation Paper). At least with respect to the FSA's client money rules (i.e., Chapter 7 of FSA's Client Assets sourcebook), we would question this. In the Lehman court case, the courts found that what looked like a "relatively straightforward and intelligible code" for the holding and return of client money was in fact "patently inconsistent and flawed in certain significant respects" with "patent errors" in both rules and guidance. Indeed, the courts decided that aspects of the rules multiplied and aggravated the client money problems faced in Lehman.

So, while we agree that the underlying conceptual structure – i.e., the client money trust – is sound, FSA's rules implementing that trust, especially on a firm's default, cannot be described as 'fit for purpose'. One of the most urgent tasks, therefore, in the reform of client money protection is a review of the regulatory regime itself to correct the deficiencies that the courts have identified.

2 Specific responses - Chapter 4 – Reconciling and returning client property

A. Question 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?

Yes, we agree that the Government should look to provide clarity over the treatment of shortfalls in client asset omnibus accounts, and as to the time as at which client's entitlements should be calculated.

It goes without saying that this topic requires careful consideration to ensure that there is clarity as to what entitlements are protected. In particular:

– is protection to be limited to client's beneficial ownership interests (accepting that these may not always be in the underlying securities, but in the firm's contractual and other legal rights against relevant securities depositaries)?

– should it extend to clients whose securities should have been segregated in the account, but were not?

– what happens should securities be taken out of or added to the omnibus account when there is a shortfall on the account (e.g. where a client sells his stock and stock is delivered out of the account), whether before or after the point of calculation of entitlement?

– should the level of protection depend upon the cause of the shortfall? (E.g. if the shortfall can be attributed to a partially-failed purchase affecting a particular client, should the shortfall be borne by that client or shared on a pro-rata basis?)

– General pools of assets for sharing of losses can cause great harm and should be avoided. Great care needs to be taken to avoid creating unwanted pools. In the Lehman Claims Resolution Agreement shortfalls are determined on a stock line by stock line basis. Entitlements and losses should follow that analysis and not any broader pooling.

Given the international nature of securities holdings and the various international initiatives in this area, we would urge the Government to look for solutions which take these into account and to participate in those international initiatives.

B. Question 36

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

We would not regard this as a matter for legal intervention.

It is not obvious to us that there is any form of widespread misunderstanding in the market as to the legal effect of rehypothecation, or as to the risks (and indeed advantages) of allowing firms to operate omnibus accounts. Consequently, we consider that mandatory warnings are not strictly necessary.

Further, it is unclear what benefit would really be delivered by a mandatory warning recommending that clients negotiate limits on the firm's right of use, if the parties are to remain free (as they should be) to negotiate limits or not. And as limits are commonly negotiated and agreed to today, it would be surprising if anyone really needed a reminder. (On a smaller point, we assume that the Government does not intend that any warnings by firms would "recommend" the negotiation of limits (see paragraph 4.34), but would merely remind clients that this is something they ought to consider.)

As to whether firms should be required to offer designated accounts rather than omnibus accounts, we again believe that this can and should be left to the parties to negotiate (given the likely costs). We would also warn that designated accounts are not the panacea that some suggest, as they also carry risks that need to be appreciated and managed:

– the greater the number of separate client accounts that a firm operates, the greater the likelihood that assets/money will be credited/debited (due to operational error) to the wrong client account, and the firm's systems and controls must be sufficiently robust to manage that risk.

– given that risk, an administrator will still have to undertake a reconciliation exercise to ensure that each account has the correct assets/money credited to it and to resolve breaks (although we would hope that this would be easier if the firm's systems and controls were sufficiently robust in the first place).

– the Government should be aware that designated client money accounts are already a feature of the FSA's client money rules, but are subject to pooling on the firm's insolvency, i.e., a client is still exposed to shortfalls on other pooled accounts, even though its designated account is whole.

In addition, it ought to be remembered that firms, including UK entities for which the UK is lead regulator, may not be able to open separate designated client accounts in overseas jurisdictions – local law might require all assets to be credited to a single account, or even regard all of the assets as belonging to the firm, regardless of the account to which they are credited.

C. Question 37

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

In the wholesale markets we do not see this as an area for legal intervention. At most, FSA might set out its expectations as to 'best practice', and then monitor how firms approach and achieve greater clarity.

D. Question 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?

This is primarily a regulatory issue so not addressed in this response, other than to say that this is an area where a balance between what is valuable to clients, but not overly expensive or burdensome, needs to be maintained. In particular given the huge volatility which accompanies a failing firm it may be impossible to avoid a breakdown in record keeping in the last few days and tougher reporting requirements may not in reality have assisted.

E. Question 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?

See response to Question 36.

F. Question 41

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

We are unable to comment on these proposals until it is clear what auditors will be asked to do, and what would then be disclosed to clients.

G. Question 42

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

We agree that there would be value in centralising CASS oversight in one approved person. However, we believe that it should be emphasized that the responsibility for a firm's compliance with its CASS obligations rests with a firm's senior management rather than just with the individual CF-29 to ensure that the firm's compliance with CASS is prioritised at the appropriate level within the firm.

H. Question 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?

We agree with the Government that the initiative shown by market participants in establishing insolvency remote vehicles is to be welcomed. Indeed, it may ultimately prove to be an effective way of managing some of the risks identified in this Consultation Paper. However, it is important that the Government does not take any action that may undermine the emergence of alternative measures.

I. Question 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?

Yes in particular firms should assess and manage the risks arising from placing client assets and money with affiliates or in jurisdictions where local laws could cause problems for the return of the assets or money on a firm's insolvency.

Question 46

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

Yes, in principle, we agree. In any event such claims should be subordinated to client claims through relevant contractual terms.

J. Question 47

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

We believe that the FSA should consult more broadly on the appropriate regime for dealing with the client money held by a firm at the time of its insolvency. The question of whether the money should be held in a single or in multiple pools should be considered as part of that broader review.

K. Question 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 submit a claim by a bar date? Should the Government impose a legal duty on an administrator or trustee to impose a bar date?

Yes, we agree that bar dates should be introduced. We see no reason why an administrator/trustee should not be subject to a legal duty to impose a bar date, subject perhaps to being able to seek the courts' consent to not imposing one.

This may require a broader reform. A bar date may protect the insolvent estate from breach of trust claims but it does not impact on proprietary rights so that a claimant can still make a claim against another claimant who has wrongfully received a trust asset even if they did not notify the trustee. A review of trust law is required to allow recipients to be protected. This is what the LBIE scheme of arrangement was intended to achieve but was blocked by the court. The Lehman Claims resolution Agreement does not protect claimants. In effect the required reform would be that any client who has not submitted his claim prior to the bar date should be restricted to his claims as an unsecured creditor.

L. Question 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 'futureproof' and do they have a limited negative impact?

We consider that the great strength and attraction of the UK financial market is the flexibility of its laws, and the freedom that firms and their clients have to agree the terms of their relationships, especially in the wholesale and institutional markets. We welcome the Government's recognition that it should not seek "to undermine the fundamental commerciality of such arrangements".

As noted above, we believe that there are elements to the Government's proposals that do require further consideration to ensure that this objective is achieved.

We are doubtful that any regulation is wholly 'futureproof' – all rules that are designed to mitigate or manage risk need to be assessed as markets change, in order to determine whether they are still performing the intended role. Further consideration also needs to be given to the application of MiFID as it impacts on affiliates and we note that this is likely to be the subject of consideration in the court of appeal on Lehman. That appeal may end up taking a long time to be finally resolved so clarity going forward would be helpful

We are unable to comment on the extent of any negative impact.

Chapter 5

We wholly endorse the views of the Insolvency Law Committee and the Regulatory Law Committee that there is no need for a separate Client Asset Trustee. We consider that the proposals in this Chapter are counterproductive and would be likely to add to the cost and complexity of the administration without giving rise to any real benefit. To have separate officeholders appointed in respect of the client assets and the general estate would inevitably lead to duplication and potentially litigation regarding the respective roles. We strongly urge the abandonment of these proposals.

A. Question 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 investment firm?

We believe the idea of a CAT is misconceived and would involve an unnecessary duplication of costs which would have to be born either by the owners of the assets or the creditors of the insolvent firm. Costs would only increase with the use of a separate firm, but the separate functions and duties would in any event involve huge duplication of effort. We recommend that the proposal is abandoned and that the adjustment of administrator's duties considered in Chapter 2 is all that is needed. An administrator appears in any event to be in the position of a trustee in relation to third party assets.

B. Question 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 methods of establishing a CAT?

As stated above we do not favour the CAT proposals at all. As the relevant assets are likely to be mixed with the assets of the failed investment bank, the proposal to vest the assets in the CAT would be productive only of litigation and uncertainty. If the CAT proposal were pursued the assets would need to remain vested in the company to the extent of its interest (which may be no more than a bare legal interest or a right of management of interests held in the name of a third party) and otherwise in the third party owner(s). Attempts to vest third party rights in a CAT could be regarded as expropriatory and an interference with property rights. This would not, however, in our view prevent the court regarding any officer with control of client assets as under the obligations of a trustee (to the same extent as the company) in relation to such assets.

C. Question 54

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

Whichever way they are funded they will undoubtedly be higher than if there were no CAT and may well be double. There could be no justification for burdening the insolvent estate, if a separate officer were dealing. There would be a case for allowing a single administrator to make a small levy on returned client assets to fund his work in sorting out and returning client assets without burdening the insolvent estate.

D. Question 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?

We do not agree with this proposal. The clarification of the aims of the administration, the introduction of a bar date, the regulatory proposals regarding the reporting of client assets and money and restrictions on the use of affiliates as the bankers of client money would be better ways of contributing to the speediest possible return of client money and assets.

E. Question 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.

We are certain that the additional costs of this proposal would be very high because of the duplicatory nature of the role, the resource intensive nature of the work and the risks of litigation. We are doubtful that it would do anything much to speed up return of assets and in some respects would slow it down. While we cannot give estimates of costs as such, we can say that the overall costs of dealing with insolvent estate and third party assets would be likely to rise by a substantial amount – probably in the range 50-100%.

The latter part of this chapter and Questions 57-61 are largely regulatory in nature and the Regulatory Law Committee has responded. Their comments raise concerns about the burden that the proposals could place on smaller businesses. We would urge that measures should be proportionate to the size and complexity of a business and not "one size fits all".

In relation to **Question 57**, we do not think that an officer of the CAA would be suited to the role of CAT unless he was also an insolvency practitioner: in any event, he would need access to the resources of the type of firm to which suitable insolvency practitioners are likely to belong. These would not be found in the CAA (as it would not be constantly dealing with insolvent investment banks) and would have to be bought in.

Question 62 asks if we have any other views on the proposals in this chapter and we would re-iterate that the CAT proposals should be abandoned.

Chapter 6

A number of the issues raised in this Chapter are addressed in the FMLC paper, Legal Proposal for normative changes to address the risk of market instability in the event of the insolvency of an investment firm, with particular reference to the problem of unsettled OTC cash equity trades of September 2009, available on the FMLC website at http://www.fmlc.org/papers/Issue140Sept09.pdf. We understand that the FMLC will be responding on the questions raised in this Chapter. Some valuable practical points are made in the AFME response, which we have seen.

We would refer you to those papers and do not propose to make detailed responses.

Chapter 7

We support the views expressed by ISDA in its response, which we have seen.

Chapter 8

As indicated above, we support the views expressed by the CLLS Insolvency Law Committee.

In particular, as the paper correctly points out, investment firms currently fall outside the scope of the Regulation on Insolvency Proceedings (EC) No 1346/2000 (the **Insolvency Regulation**) and, unless the investment firm also has a deposit-taking licence, it is also carved out from the scope of Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions (the **Winding Up Directive**). It has been our understanding that the European Commission did intend to propose either separate European legislation on similar lines to the Winding Up Directive or the extension of that Directive to cover investment firms. We believe that the UK should look for the development of such legislation and actively participate in its development.

City of London Law Society,
Financial Law Committee,
26th March 2010

Working Party Members:

Dorothy Livingston, Herbert Smith LLP (Chairman)
David Ereira, Linklaters LLP
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Investment Banking Resolution
HM Treasury
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19 March 2010

Dear Sir / Madam

Response of the Insolvency Law Committee of the City of London Law Society to the consultation document dated December 2009 entitled "Establishing Resolution Arrangements for Investment Banks" (the Consultation Paper)

Introduction and executive summary

1. The City of London Law Society ("CLLS") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

2. The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the Consultation Paper has been prepared by the CLLS Insolvency Law Committee.

3. We are grateful for the opportunity to respond to the Consultation Paper. In view of the expertise of the CLLS Insolvency Law Committee, we have restricted our comments to the matters raised in Chapters 2, 5 and 8 of the Consultation Paper although we have also addressed a few additional questions from other chapters where we consider that these questions could have a significant impact upon the insolvency analysis. Although the other chapters raise important issues that could well affect how an investment firm is dealt with once an insolvency process is commenced, we understand that others (including other Committees of the CLLS) are intending to respond to these chapters.

4. In summary, we consider that a strong case needs to be made before any new insolvency procedure or modified insolvency procedure is introduced. There are now over 20 "special" insolvency procedures in the UK. This is hard enough for a UK practitioner to grasp, let alone an overseas lawyer. If this proliferation were to be replicated in every jurisdiction where an investment firm has operations, the number of insolvency procedures would be phenomenal. As well as adding to the overall complexity of the UK insolvency framework, there are related issues such as secondary legislation not always being available prior to the commencement of the

special procedure (e.g. railways and public private partnership special administrations) and the uncertainty that comes with any new procedure not having been tested through the courts before its utilisation.

5. Furthermore, we consider that the existing UK corporate insolvency procedures are extremely flexible and perfectly adequate for dealing with an insolvent investment firm, particularly in light of some of the pre-insolvency suggestions that have been made in the Consultation Paper. Although a case can be made for saying that deposit-taking banks and investment firms should be treated differently post insolvency because of the systemic risk that they may pose, many of the issues that an insolvency practitioner will face will be the same as for other large international corporates (e.g. Enron or World Com). Although the administration of Lehman Brothers International (Europe) (**LBIE**) is clearly highly complex, it now appears that distributions in relation to client assets may be made no less promptly than through the US SIPA process. Hence, any initial perception that there may have been that the US system gives rise to a more speedy resolution of the issues is likely to be dispelled by the time any legislation arising from the Consultation Paper is proposed. The administration of LBIE is obviously being carried out under the existing framework and Schedule B1 to the Insolvency Act 1986.

6. For these reasons, we very much support a "light touch" approach to any modifications to the existing administration regime for an insolvent investment firm. We wonder whether the proposals in Chapter 2 will make a significant difference in practice as we suspect that any administrator would follow principles similar to those set out in the proposed special administration objectives in any event (as indeed is demonstrated by the case of LBIE). Having said that, we do not consider that it would do any harm to set out the special objectives (and indeed we can see that both the administrator and the counterparties may welcome the clarity and transparency in this regard) provided that this is done in a way that maintains flexibility and allows the administrator to exercise a degree of discretion on a case by case basis. This will ensure that the special objectives do not become out of date and will assist in a "one size fits all" approach. Rather than lowering the standard of care for an administrator's duties (or attempting to come up with an alternative formulation for the standard of care), we suggest that an administrator will be sufficiently protected if the duties are linked to the pursuit of the special administration objectives.

7. We do think, however, that the proposals regarding a bar date for client asset and client money claims would be a useful modification to the insolvency legislation. The problem with the existing legislation is that, while administrators can impose a bar date for the submission of proofs of debt regarding unsecured claims and can, with the assistance of the court, impose a bar date for the submission of information regarding trust claims, such a bar date does not release proprietary claims in relation to the assets and so a recipient of any distribution from the administrators remains at risk that a third party will seek to attach those assets. We consider that it should be a matter for the discretion of the administrators as to whether a bar date is imposed in any particular case.

8. We are much more concerned about the proposals in Chapter 5 of the Consultation Paper and, in particular, the appointment of the Client Asset Trustee (**CAT**). We consider that these proposals are likely to add to the cost and complexity of the administration without giving rise to any real benefit. The experience in relation to LBIE has shown that it is just not possible to separate out the unsecured positions from the client assets; these have to be dealt with together in order to determine what client assets can ultimately be returned to a beneficiary on a net basis. The position may be different for a pure custodian but, even in such a case, there is no reason why a separate team at the accountancy firm from which the administrators are appointed cannot deal with the client assets (as PwC have done in relation to LBIE). To have separate officeholders appointed in respect of the client assets and the general estate would inevitably lead to duplication and potentially litigation regarding the respective roles.

9. On the cross-border side, we are pleased that HM Treasury is aware of the difficulties in this regard as it is essential that there is a harmonised, international approach to the insolvency

issues. We doubt that the proposals in question 13 that international entities be able to "opt-in" to the UK measures will be workable. It is unlikely that the overseas court would cede jurisdiction and so the entity in question would simply be subject to two (or more) potentially competing regimes. There is no easy answer to the cross-border issues and ultimately we suspect that the UK Government can only legislate for UK firms while monitoring closely the international developments referred to in Chapter 8 to ensure that the UK proposals are not inconsistent with these developments. In this regard, we note that there is no mention in Chapter 8 of a proposed directive, from the European Commission, on insolvency proceedings in respect of a investment firm. As the paper correctly points out, investment firms currently fall outside the scope of the Regulation on Insolvency Proceedings (EC) No 1346/2000 (the **Insolvency Regulation**) and, unless the investment firm also has a deposit-taking licence, it is also carved out from the scope of Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions (the **Winding Up Directive**). It was our understanding that the European Commission did intend to propose separate European legislation for insolvent investment firms and it would be worth trying to find out where the thinking has got in this regard.

10. We have attached as Annex 1 to this paper a table which responds in more detail to the specific questions in the Consultation Paper. Any member of the working party (listed in Annex 2) would be glad to amplify any of these comments if requested.

The Insolvency Law Committee of the City of London Law Society
19 March 2010

Annex 1

Chapter 1 (Introduction)	
1.	*Do you have any comments on the proposed definitions of investment firm for the purposes of this work?* We note that the proposed definition would include a deposit-taking institution and therefore it is essential that sufficient thought is given to how the proposals in the Consultation Paper would fit with the special resolution regime and special insolvency regimes for deposit-taking institutions in the Banking Act 2009. This is considered further below. It is also important that thought is given to how the proposed definition would fit with cross-border legislation such as the Insolvency Regulation and any insolvency legislation that the European Commission may propose in the future in relation to investment firms. The Insolvency Regulation carves out "investment undertakings which provide services including the holding of funds or securities for third parties" and so this could well provide the definition for an investment firm in any European insolvency legislation in the future. This would appear to be covered by the proposed Condition 2 depending on the definition of client assets and, in particular, whether this is to include client monies (which in our view it should).
Chapter 2 (Enabling an Orderly Resolution)	
2.	*Do you agree with the Government's proposals for special administration objectives and associated policy measures? Are there any supporting levers not considered in this document that would be critical for the effective functioning of the special objectives?* As referred to above, while we consider that most administrators would already follow the objectives suggested in paragraph 2.16 of the Consultation Paper, we consider that there may be some merit (in terms of transparency for both the administrator and the counterparties) in having clear special administration objectives so long as the administrator maintains sufficient flexibility so that these can be adapted and applied, as appropriate, on a case by case basis. It is essential, therefore, that these are expressed in terms that are sufficiently broad and flexible to accommodate the vast variety of business models pursued by investment firms. In other words, the special objectives should refer to broad principles rather than being prescriptive as to how these objectives should be achieved. As the Consultation Paper recognises, it is a policy decision as to whether the return of client assets should be given procedural priority over the interests of unsecured creditors. It is important to recognise that even a procedural priority can have a practical impact on the quantum of returns to unsecured creditors. An extreme example would be in relation to a sale of the business. The administrators may receive two offers for the business, one from a purchaser who has the infrastructure and contractual relationships already in place to ensure a speedy return of the client assets and one who does not have the infrastructure and relationships but is willing to offer more for the business (thus resulting in a greater return for unsecured creditors). If the return of client assets is procedurally prioritised through the special administration objectives, the administrators would be required to accept the first offer at the expense of the unsecured creditors. Even outside of such an extreme example, where unsecured creditors have been procedurally subordinated to the

	beneficiaries of client assets and monies, there could be a reduced return to unsecured creditors simply because of the increased timeframe in making distributions to them (and therefore the additional administration expenses that are likely to be incurred). We have considered three options in relation to the prioritising of the special administration objectives: (a) the first is for the legislation to set out the order in which the administrators must pursue these objectives (as is the case with the bank insolvency procedure (BIP) and the bank administration procedure (BAP)). This has the advantage of being clear from the administrators' perspective and may reduce the risk of challenge by third parties. However, it is the least flexible of the approaches and, from a policy perspective, the unsecured creditors may question why they are being procedurally subordinated; (b) the second is for the legislation to set out the special administration objectives but without attempting to order them and then to provide that the administrators shall pursue the objectives in a manner which best protects the interests of the creditors and beneficiaries of the firm. This would leave it to the discretion of the administrators as to how to achieve the objectives in any particular case. While this is less certain than the first approach and the risk of challenge could therefore be higher, we consider that it would allow the administrators to adopt an approach that was appropriate for the particular investment firm in question and so is to be preferred; (c) the third approach, which is a compromise between the two above, follows the approach in Schedule B1 to the Insolvency Act 1986. This does seek to order the objectives but allows the administrators to pursue a lower objective if they consider that it is not reasonably practicable to achieve the higher-ranking objective or if the lower objective would achieve a better result for the creditors as a whole. The problem with this approach in the current context is that there may be a conflict between the interests of the unsecured creditors and the beneficiaries of client assets and monies and so the concept of what would achieve a better result for the creditors as a whole would need to be adapted to reflect the interests of the beneficiaries. In terms of the objectives themselves, we consider that these should include: • the prompt return of client assets and client monies (rather than seeking to prioritise this objective for the reasons given above). Careful consideration needs to be given to the definition of client assets and client monies to ensure that these fit with the FSA definitions in the Client Assets Sourcebook (CASS); • co-operating with the relevant authorities in the interests of achieving stability in the financial markets. We think it is worth adding this objective in view of the potential systemic risk that the insolvency of an investment firm might pose; • ensuring timely engagement with market infrastructure bodies such as payment and settlement systems and clearing houses. While it cannot do any harm to include this as an objective, we note that the problem can often be the reverse – i.e. lack of communication by the market infrastructure bodies regarding how they will behave post an insolvency of a member. We hope that this will be addressed by proposals elsewhere in the paper; • where this is in the interests of the creditors and beneficiaries of the firm, providing services and facilities to business transferred both in the run up to and post-

	insolvency. This objective should not be drafted too widely as there is a significant difference between BAP (which only ever arises following a transfer of the business) and the proposed administration of an investment firm where there may, or may not, be a transfer. Furthermore, we understand that, in the case of Lehman Brothers Inc (LBI), there is ongoing litigation with Barclays concerning the scope of what was sold to them and an unqualified duty to co-operate with a purchaser may adversely affect the interests of the creditors and beneficiaries in the event of such a dispute; • rescuing the investment firm or its business as a going concern or achieving an orderly winding down of the investment firm's affairs, as appropriate. While we suspect that rescue will not be possible in the vast majority of cases, we do not think it should be excluded from the objectives in case there is a prospect that it could be achieved (for example through a sale of the business as a going concern).
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?* We understand from conversations that we have had with the administrators of LBIE that concerns regarding personal liability have not been a major factor and, in particular, have not prevented them from taking any actions which they would otherwise have done. We also think it is important that the administrators have clearly defined (and properly understood) duties in order to ensure that the UK administration regime has a high degree of credibility both domestically and overseas. The problem with any alternative formulation of the duty (such as, for example, a duty to act in good faith) is one of certainty: one person's idea of good faith could be another's idea of bad faith. Instead we support the proposal that the duties be clearly tied to the special administration objectives. If the legislation clearly states that the administrators must perform their functions with a view to furthering these objectives (see paragraph 3 of Schedule B1 to the Insolvency Act 1986), we consider that it would be difficult for a counterparty to bring an unfair harm or negligence application against the administrators in circumstances where they were acting in accordance with those objectives.
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?* We do not consider that this is appropriate. Directors and administrators fulfil two entirely different functions; the former have a primary duty to the firm's shareholders at least while the firm is solvent, the latter have a primary duty to the firm's creditors and beneficiaries. See our response to question 3 above.
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?* We do not consider that this is appropriate in light of the role that the English court currently plays in an insolvency process. The approach of the English judiciary to date has very much been to leave commercial judgments to the insolvency officeholders who, in the judges' views, have more experience of life at the coal-face than the judges do. We consider that there is a lot to commend this process as it reduces the costs associated with large numbers of court applications and lets those with the relevant experience make the commercial judgments.

	Furthermore, it should be remembered that the English court system is very different from that in the US. While it is becoming court practice in the UK to have a single judge allocated to a particular insolvency proceeding, this will not always be the case. There are no "specialist" insolvency courts (as there are in the States) and the judges tend to be ex-barristers rather than ex-insolvency practitioners with specialist knowledge of the proceedings in question. Finally, in our experience, when an application to court is urgent, it is usually possible to get before a judge very quickly (often out of court hours) and so we do not see any need for an expedited court procedure.
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?* See our response to question 3 above.
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 financial stability? What specific modifications could the Government consider applying?* We do not consider that any changes are necessary. The test (as the Consultation Paper points out) is whether the directors took every step to minimise loss to creditors on becoming aware that an insolvent liquidation is not avoidable. If it is in the interests of creditors to pursue a resolution plan or other resolution actions as agreed with the FSA, the directors will not be liable under the existing legislation. If the resolution plan is not in the best interests of creditors, it is questionable as to whether the directors should be adopting that plan. If the resolution plan is intended to promote financial stability (for example) but is not necessarily in the interests of the firm, its creditors and beneficiaries, this would put the directors in a difficult position, not just in relation to their wrongful trading liabilities under section 214 of the Insolvency Act 1986 but also in relation to their common law or statutory duties. If it is the intention to protect the directors in these circumstances, careful thought will need to be given to how the protections are worded as it could lead to a loss of confidence in the corporate governance of UK investment firms if directors are absolved from liability in circumstances where (it could be argued) they should be at their most vigilant. We have considered whether the reference to creditors in section 214 of the Insolvency Act 1986 ought to be broadened (in the case of an investment firm) to include beneficiaries of client assets and monies. We do not consider that this is strictly necessary as such beneficiaries are potential creditors of the firm if and to the extent that the firm breaches its fiduciary duties in relation to such assets and monies. However, in light of the narrow definition of "creditors" that was taken by the court in relation to the proposed LBIE scheme of arrangement, we would have no problems with a clarificatory amendment to section 214 to refer to the firm's beneficiaries as well as creditors when taking every step to minimise their loss.
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 described in Box 2A?* We consider that, in order to minimise the number of insolvency proceedings, the special administration regime for investment firms should become the standard administration procedure for these types of entity. Hence we consider that the regime should be commenced in exactly the same way as the standard administration procedure. In other

words, the directors, shareholders or creditors of the firm should be able to commence the process (in addition to the rights the FSA has to do so under the Financial Services and Markets Act 2000) on the grounds that the firm is unable to pay its debts or is likely to become so. Provided that no equivalent of the special resolution regime for deposit-taking banks is introduced for non-deposit taking investment firms (see our response to question 15), we do not consider that it is necessary to introduce conditions linked to financial stability.

In considering how the special administration regime might interact with the Banking Act 2009 for an investment firm that also accepts deposits (referred to below as "mixed bank"), we consider that it is necessary to consider two scenarios:

(a) circumstances where the mixed bank has been subject to the special resolution regime and, in particular, a property transfer instrument. Pursuant to section 34(7) of the Banking Act 2009, the property transfer may include a transfer of client assets and client money (although it need not do so) and it would be useful if confirmation could be given that the powers under section 34(7) would not be used so as to re-write the terms on which the client assets and client money are held by any transferee. In these circumstances, but for any changes that may be made to co-ordinate the two processes, the residual mixed bank may well have been placed into the BAP. The interaction between the investment firm special administration regime and the BAP will depend on what exactly has been transferred by the property transfer instrument (and whether this includes the client assets and client money) but provided that the investment firm special administration regime includes, as one of its objectives, the provision of services to the transferee, it should be possible to disapply the BAP and rely on the investment firm special administration regime in these circumstances;

(b) circumstances where, but for any changes made to co-ordinate the two processes, the mixed bank would have been placed into the BIP. In these circumstances, it would seem sensible to add to the special administration objectives for the investment firm special administration regime an objective similar to Objective 1 in section 99(2) of the Banking Act 2009 (to protect eligible depositors) so that the investment firm special administration regime could be used instead of the BIP. This objective would clearly only apply in the case of a mixed bank and we suspect that, from a policy perspective, you would want to ensure that this objective had procedural priority so as to be consistent with the approach taken in paragraph 99. In practice, however, we suspect that any administrators would pursue the special objectives in relation to eligible depositors in parallel with the other objectives including those in relation to client assets and money.

We note that, in Box 2A of the Consultation Paper, you state that no estate or client assets would be used in the payout of eligible depositors. We agree with this statement in relation to compensation payments made by the FSCS. Furthermore we agree that client assets should never be used to protect eligible depositors. However, we are not convinced that estate assets could never be used in transferring the relevant accounts to another financial institution pursuant to section 99(2)(a) of the Banking Act 2009. Much depends on how this section is to be construed but it is likely that a third party institution would only accept a transfer of deposits (i.e. liabilities of the bank concerned) if matching assets were also transferred to it. Part 2 of the Banking Act 2009 does not state that these matching assets must always be provided by the FSCS rather than the failed bank. In this regard, we refer to paragraph 13 of our response to Parts 2 and 3 of the Banking Act 2009 (accessible at: http://www.citysolicitors.org.uk/FileServer.aspx?oID=488&lID=0).

9.	*Is there a case for considering 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?* We would strongly discourage you from introducing any changes regarding the priority of post-administration funding or funding made immediately prior to administration. As the Consultation Paper notes, this was the subject of a recent consultation process by the Insolvency Service in relation to general corporate administration and the issues raised are highly complex particularly as secured creditors' proprietary rights are likely to be affected. This could ultimately affect a lender's willingness to lend or an investor's willingness to invest. The Insolvency Service has decided (for good reason) not to introduce changes of this nature at the current time. Ultimately the lessons learned from the Lehman Brothers experience (and the difference in the ability of LBI and LBIE to raise funding prior to the commencement of insolvency proceedings) show that, what matters most to lenders and investors is whether there is Government or State support for that lending or investment. We doubt that there is anything that could be done on a legislative or regulatory front that would encourage third parties to lend without that support.
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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.* It is important to bear in mind the costs associated with any risk assessment in relation to the new regime that will need to be taken 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 to ensure that, for example, events of default are triggered by the new procedure. In this regard, the greater the changes made by the proposed legislation, the more extensive the legal analysis is likely to be. If anything is unclear, this will also add to the costs of the risk assessment. Hence we doubt that the costs will be negligible although we are not able to quantify what those costs would be.
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.* This question is beyond the scope of the Insolvency Law Committee and so we leave it to other interested parties to respond. We would note in passing that, in the LBIE administration, the PwC website has been an effective method of communication including by written statements and, in the early days, short video briefings and we would encourage the use of such tools in the future.
12.	*The Government considers the costs to market participants of a resource centre providing best practice guidance to administrators, and plans for coordinated 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 in the paragraph above? If not, please provide an*

	estimate of the costs that are likely to occur, stating your assumptions. Agreed.
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?* As stated above, we do not think this is workable as we very much doubt that the overseas court would cede jurisdiction to the UK in which case the international entity would be subject to two possibly competing regimes.
14.	*Are there any other specific issues in relation to cross-border investment firms, not considered here or in Chapter 8, that need to be addressed?* As referred to above, we would like to know whether the European Commission still intends to adopt European legislation relating to the insolvency proceedings of an investment firm where neither the Insolvency Regulation nor the Winding Up Directive applies. We think it is important that any UK legislation is consistent with any such European legislation (or there is scope to modify the UK legislation if such European legislation were to be introduced in the future).
15.	*The Government welcomes views on the extent to which the package of measures proposed in Chapters 2 and 3 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?* We consider that the proposals in Chapters 2 and 3 would be sufficient to achieve the effective resolution of a failed investment firm and we do not consider that those proposals need to be supplemented by those in Chapter 5. We are also strongly against the idea of a special resolution regime for an investment firm. While it is arguable that this may be necessary to protect depositors and to restore confidence in the case of a failing deposit-taking institution, we consider that the significant interference with contractual and proprietary rights that such a regime involves cannot be justified in the case of a failing investment firm. The safeguards that would be necessary to protect legitimate expectations, trust property, set-off and netting would be even more complex than in the case of a bank and we would strongly discourage you from such a route.
Chapter 4 (Reconciling and returning client property)	
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?* We think this would be useful as there is currently a tension between a pro-rata sharing of shortfalls (which may well be the most practicable method of sharing such losses) and a "tracing" approach which may allow particular beneficiaries to identify "their" assets ahead of other beneficiaries. This is not likely to cause an issue in the LBIE administration as the level of shortfalls is expected to be very low (less than 3% of the client assets) but it could be an issue in a case where the shortfalls are higher. However, a decision first needs to be taken as to whether client assets are to be treated on a pooled basis or a stock-line by stock-line basis and whether a distinction needs to be made between pure custody assets and assets held pursuant to prime brokerage and other arrangements.

	In relation to the first point, we consider that it is more consistent with the UK legal system (which is based in trust law) for client assets to be treated on a stockline by stockline basis rather than securities of different types being pooled. In other words, if a client has an interest in M&S shares, that client should share any shortfalls re M&S shares pro rata with any other clients with an interest in M&S shares but those M&S shares should not be pooled with (say) Microsoft shares. Any system which relies on pooling (for example the UK CASS rules in relation to client money or the US SIPA rules in relation to client assets) results in a slower return of the monies or assets in question as it is not generally possible to make distributions until all the monies or assets have been collected in and all the claims determined. As for whether there should be separate "stockline" pools for pure custody assets and other types of client assets, we can see why a client whose only relationship with the investment firm is a custody one would want their assets to be separated from other types of client assets where the risk of shortfalls (for example as a result of improper use of rights of rehypothecation) might be higher. We note that the LBIE Claim Resolution Agreement separates custody and non-custody assets for precisely this reason. We wonder whether this decision is best left to the insolvency practitioner who can decide on the facts of the particular case whether there should be separate stockline pools for custody and non-custody assets (although the counter-argument is that the market may welcome the certainty as to how shortfalls will be dealt with).
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?* We would strongly support this proposal. In our experience, there may be few contractual restrictions on the use of affiliates in other jurisdictions as the bankers of client money and it is not uncommon that, in a group insolvency scenario, those affiliates will fail at the same time as the investment firm in question. We think it is important that investors are made aware of the fact that they will always be subject to the credit risk of the bank holding the client money at the end of the day; even in jurisdictions that recognise the trust, the relationship between a bank and a depositor will generally be one of debtor and creditor (rather than trustee and beneficiary). The consequences for an investor are clearly much greater, however, when the bank fails at the same time as the investment firm. As this is more likely to happen when the bank and the investment firm are part of the same group, there is an argument for prohibiting (or at least limiting) the use of affiliates as the bankers of client money. Of more concern than the risk of there simply being a debtor / creditor relationship between the bank and the depositor are local insolvency law provisions that require the subordination of affiliate claims. The dispute between the insolvency officeholder of Lehman Brothers Bankhaus AG (Bankhaus) and the administrators of LBIE regarding client money deposited with Bankhaus has caused real concerns in the market in this regard; if LBIE (rather than the underlying clients) is treated as being the creditor of Bankhaus, and LBIE's claim is subordinated on the basis that it is an affiliate of Bankhaus, this will obviously have a very significant impact on any recoveries from Bankhaus in relation to the client money. There may well be jurisdictions in which these types of concern do not arise and so a blanket prohibition (or restriction) on the use of affiliates as the holders of client money may not necessarily be appropriate (subject to the points made above regarding the double impact of an insolvency of the investment firm and the bank). An alternative option would be to require the investment firm to obtain a legal opinion from the jurisdiction in question confirming that the protections given by CASS would be respected in the local jurisdiction and there would be no subordination of claims on the basis of the affiliate relationship.

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?* We consider that provisions empowering an administrator to set a bar date by which beneficiaries would be required to submit information regarding their client money or client asset claims would be beneficial and could lead to an earlier return of the money or assets in question. It is important that these provisions should not be too prescriptive and so the length of the notice of the bar date (and indeed whether a bar date is appropriate at all) should be matters for the administrator's discretion. There are no provisions in the existing insolvency legislation regarding a bar date for trust (as opposed to unsecured) claims. Administrators can, with the assistance of the court, impose a bar date for the submission of information regarding trust claims (as the administrators of LBIE have done) but such a bar date does not release proprietary claims in relation to the assets in question and so a recipient of any distribution from the administrators remains at risk that a third party will seek to attach those assets. We consider that, if a beneficiary fails to submit information regarding its claim by the bar date, the administrators should be entitled to determine the beneficial interest of that beneficiary by reference to the books and records of the investment firm. The legislation should provide that the beneficiary loses its right to trace the assets into the hands of a third party so that distributions made by the administrators, in reliance upon information submitted by the bar date, cannot be overturned. We agree that, if information regarding a trust claim is submitted after the bar date, that claim should be converted into an unsecured claim against the estate. We are not sure we understand the second proposal in paragraph 4.82 regarding a subsequent pooling event. There are currently no provisions in CASS requiring a pooling of client assets (nor in our view should there be – we refer to our answer to question 35 in this regard). We also expect that, in many cases, there will be a single distribution in relation to client assets and so no opportunity for a catch-up distribution.
Chapter 5 (Providing clear and effective support for clients)	
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?* For the reasons given above, we are strongly against the idea of the CAT as a separate officeholder to the administrators of the investment firm. The experience in relation to LBIE has shown 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. This may be different for a pure custodian where no amounts are due from the beneficiary to the custodian but, in such a case, it would be possible for the administrators to come up with proposals for an early return of the custody assets. The proposals in relation to the CAT also fail to appreciate that 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. In this regard, it should be noted that, in the client money litigation involving LBIE, it has been assumed (for the purposes of the litigation) that certain parties were entitled to client money protection because the contractual position is so complex that this has not yet been determined as a matter of fact. Pending a determination of whether there is a trust relationship, it is not clear whether the administrators or the CAT would be responsible for dealing with such money or

	assets. As there could never be a clear delineation of roles (except perhaps in the case of a pure custodian), it is clear that there would be a degree of duplication between the tasks performed by the administrators and the CAT. This would lead to an increase in the costs of the insolvency process overall while achieving very little benefit. In light of our response to question 52, we have not responded to various of the questions set out below.
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?* See our response to question 52. Without prejudice to our view that there should be no CAT, we think the second of the two proposals in paragraph 5.12 is the only workable one as there may be prohibitions on transfer, registration requirements, clearing house requirements and other restrictions which prevent the assets being vested in the CAT rather than the company.
54.	*Should the costs of the CAT be funded from the client money and assets of the firm, or from the insolvent estate?* See our response to question 52. Without prejudice to our view that there should be no CAT, in light of the role that is proposed, we can see little basis for a suggestion that the CAT should be paid from the general estate rather than the client money and assets.
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?* See our response to question 52. We consider that the proposals in Chapter 2 (and in particular the clarification regarding the special administration objectives), the introduction of a bar date, the regulatory proposals regarding the reporting of client assets and money and restrictions on the use of affiliates as the bankers of client money (as referred to above) would be better ways of ensuring a speedy return of client money and assets.
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.* We do not agree as we consider that the appointment of the CAT would lead to additional costs and would not result in a faster return of client money and assets. We are not in a position to provide an estimate of the additional costs.
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?* In view of our answer to question 52, we do not propose to answer this question.
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?* We consider that others (including the Regulatory Committee of the CLLS) are better

	placed to answer this question.
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?* As the FSA does not have a direct economic interest in the client money or assets in question, we do not think it would be appropriate for the FSA to be granted powers to sit on the committees by right or to be able to vote on the matters considered at the meetings of such committees (e.g. on administrator's proposals). We have no problem with the idea of the administrators inviting the FSA to attend committee meetings in an observatory capacity where the administrators considered that this was appropriate. We would also expect the administrators to liaise closely with the FSA (and indeed we have suggested that this be set out in the special administration objectives).
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?* We consider that others (including the Regulatory Committee of the CLLS) are better placed to answer this question.
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?* We consider that others (including the Regulatory Committee of the CLLS) are better placed to answer this question.
62.	*Do you have any other views on the establishment of a CAT or CAA that the Government should consider?* We refer to our answer to question 52.

Annex 2

Members of the CLLS Insolvency Law Committee's Working Group

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24 March 2010

Dear Sirs,

Response of the Regulatory Law Committee of the City of London Law Society to the HM Treasury consultation document dated December 2009 entitled "Establishing Resolution Arrangements for Investment Banks" (the "Consultation Paper")

The City of London Law Society ("**CLLS**") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Regulatory Committee, whose Members advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

We are grateful for the opportunity to respond to the Consultation Paper and for your agreement to extend the deadline to accommodate our response. In view of the expertise of (and having had the opportunity to read the responses of) the CLLS Insolvency Law Committee (the "**Insolvency Committee**") and the CLLS Financial Law Committee (the "**Financial Committee**") covering the matters raised in Chapters 2, 4, 5 and 8 of the Consultation Paper, our comments are primarily directed to the other sections of the Consultation Paper, although we have addressed issues raised in these chapters where we consider that these questions could have a significant impact on the regulatory analysis. Although the questions or chapters that we have not responded to raise important issues that could well affect how insolvent firms are dealt with, we consider that others (including the other committees of the CLLS) are better placed to respond.

1. **Chapter 1 - Definition and Scope**

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

One aspect of the consultation that makes a detailed response difficult is the lack of a clear definition as to who will be caught by the new regime. A number of different phrases are used throughout the paper:

2.1: "investment firms";

2.7 and 2.26: "large and complex investment firms";

3.28: (referring to the May consultation) "investment firms, particularly those that are systemically important";

3.32: "in addition to systemically important investment firms, firms with client assets and monies may also fall within the scope of this proposal".

The Financial Services Bill requires Resolution and Recovery Plans to apply to "authorised persons of a specified description".

In our view, until there is clarity as to the firms who will be subject to the proposed regime, it is difficult to comment on whether the proposals are proportionate. Our submission proceeds on the basis that only firms of systemic importance will be caught. We acknowledge that the concept of what is systematically important needs further thought.

There also appears to be some confusion in the Consultation Paper about the role of investment firms. Paragraph 2.8 makes a broad generalisation that investment firms have "money and assets held on trust for clients, complex counterparty and financing positions, and collateral assets and liabilities". Whilst this may be true for a number of investment firms, the definition of an "investment firm" is extremely wide and would catch a large number of institutions who do not have any of the aspects described in paragraph 2.8. A company could be FSA regulated as an investment firm because it provides advice to clients and receives and transmits their orders to third parties. Such a firm would not fall within with the description in 2.8, nor would it be sensible for any such firm to be subject to the complex resolution arrangements described in the consultation.

In our view, many of the arrangements described in the Consultation Paper only make sense for firms of genuine systemic significance. This would exclude many investment firms. Such a definition could be derived from the FSA's proposals relating to liquidity requirements, or by the way in which the FSA currently grants permissions. For example, if HMT's policy view is that any firms who hold client money or assets on trust ought to be caught by this regime, then that could be achieved using the FSA's existing permissions and definitions. Even then, we are of the view that there are many firms of no systemic importance who have permission to hold client money and assets and, therefore, caution against using such a definition.

Inherent in much of the drafting is a lack of clarity about the underlying policy. Some of the proposals arguably should apply across investment firms which carry on particular activities regardless of systemic importance. In particular, the creation of a special administration objective preferring (as a procedural matter) the return of client assets and money which applies only to clients of a systemic investment firm appears to prejudice the position of clients of non-systemic investment firms, and would give clients of investment firms legal uncertainty as to their position on failure of the firm (which will be less favourable if the firm is not systemic). We would query whether this would be a good outcome for clients of UK investment firms.

As the authorities move to more concrete proposals it will be key that the scope of each element of the proposals is clearly defined.

2. Chapter 2 - Enabling an Orderly Resolution

2.1 Insolvency Regime

Q2. Do you agree with the Government's proposals for special administration objectives and associated policy measures? Are there any supporting levers not considered in this document that would be critical for the effective functioning of the special objectives?

In principle, we support the introduction of a special administration regime for investment firms that are systemically important.

However, we do have a concern with the return of client money or assets if the return is to only be made on the basis of confidence rather than certainty, as the return could end up proving to be preferential. At the moment, without an obligation to prioritise FSA clients, we do not think an administrator would be comfortable in prioritising in the manner set out. In this regard, we agree with the position adopted by the Insolvency Committee in their response to this Consultation Paper.

We do not think that the creation of setting up a Client Assets Trustee would assist the Government's objectives for the reasons set out in the response provided by the Insolvency Committee.

2.2 International issues

Q13 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?

We are not aware of circumstances where other countries would be prepared to allow branches based in the UK to be wound-up in accordance with UK, rather than local law. To this extent, we agree with the opinions set out in the Insolvency Committee's response at paragraph 7 and their responses at 13 and 14 in Annex 1.

3. Chapter 3 - Requiring Firms to Manage For Failure

3.1 BROs

Q16 Do you have any views on the coverage or detail of the BRO's responsibilities as outlined here? Are these consistent or compatible with existing templates for the corporate governance structure of firms?

In our view, requiring firms to appoint a BRO is a sensible measure. We think that, without any such requirement, boards of directors would be likely to appoint one of their number to carry out a similar role. However, we think it is important that there is a time limit post-insolvency after which a BRO should no longer be required to continue in that role.

We have two comments on Table 3B. Firstly, in relation to investment firm resolution plans in distress situations, we do not think that the BRO would be in a position to oversee the effective implementation of a resolution plan. In these circumstances, we would expect the administrator to be in control of the company, and think it would be unfair for the BRO to be responsible at this time.

Secondly, in relation to Business Information Packs, in distress situations, we think that a requirement that the BRO ensures that they are "supplemented with information on trading positions" is unrealistic as these are likely to be in a permanent state of flux. Instead, we think the BRO's role should be to show the administrator how to find this information.

We note in addition that a potential conflict of interest may arise between the duties of the BRO under the resolution regime, and the duties incumbent on him as a senior manager or officer of a company. In a distress scenario, an obligation on the BRO to commence limiting risk and/or prepare for failure under the resolution regime for the benefit of the financial system as a whole, may place him in conflict with his duties to act in the best interests of the company. Clear rules on how such a conflict would be managed or regulated in practice is a key element of a working living will.

Q17 Do you agree with the basic policy of establishing a role for business resolution officers 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?

Yes.

Q18 What are your views on the nature of appointments 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?

Yes.

3.2 Internal and market-facing actions

Q20 Do you agree that investment firm resolution plans can consist of internal actions followed by market-facing actions as proposed above?

In principle, we agree that this can be the case. However, it is important that market-facing actions neither alert other market participants to the firm's situation, nor favour one type of creditor over another. If market-facing actions are required to be carried out at a time when a firm is not yet in administration, they are likely to accelerate its decline into insolvency rather than allow any recovery plan to work. If a firm is considering the sale of an asset in order to maintain itself as a going concern, and is required to undertake market actions that would alert other participants to its situation, the deal to sell that asset would be affected.

In addition, in Box 3.C, the suggestion that, at the pre-insolvency stage, a firm should "begin reconciling and returning client assets and monies" may not be in the interests of the company. If, for example, the most important business line of a firm involved its holding client assets and monies, closing that business line would accelerate the decline of a firm into insolvency, rather than allow an opportunity for a recovery plan to be effective. We consider this is an example of the consultation paper potentially preferring creditors who are FSA clients over other creditors.

The implementation of wind-down plans necessarily must take effect pre-failure. This gives rise to corporate governance concerns. Senior management are generally required as a matter of corporate law to act in the interests of the institution while it is solvent, and in those of creditors on and following insolvency. A requirement to commence limiting risk and/or prepare for failure in the interest of the wider financial system would place management in a conflict between their duties to the institution (or creditors) on the one hand, and their duties to the wider financial system on the other. That conflict could ultimately carry legal liability for the senior management of the institution if their implementation of the wind-down plan is successfully challenged by shareholders or creditors following a failure of the institution. This conflict would need to be dealt with in order to enable wind-down to be a tenable decision for management.

3.3 BIPs

Q24 Do you agree that business information packs will be useful to administrators and will fulfil the Government's objectives for a managed wind-down of investment firms?

Yes. However, the information contained in business information packs should be designed to be useful to a potential administrator, rather than the FSA. The principle behind a business information pack should be to help an administrator navigate their way around the firm, rather than to attempt to provide up-to-date information at all times in case an insolvency event were to occur.

3.4 **Continuity of service - employees**

Q27 The Government would welcome views on what incentives and disincentives are likely to be effective and whether there are any concerns with the ones suggested above.

There are no concerns with the incentives and disincentives suggested in the Consultation. An additional disincentive might be a requirement for firms to notify the FSA of an employee who did not comply with continuity of service requirements.

The Government needs to understand that there is a risk that continuity of service contracts might be used on a widespread basis. That is because it is not always clear, prior to an insolvency, which employees need to be retained for the longest period and, given the benefit to an employee of having 90 days continued employment post-insolvency, there will be pressure on employers to include these requirements in employees' contracts. Further, we would not expect employees to be required to work 90 day periods unless the administrators could guarantee to continue to pay them on their existing terms.

3.5 **Continuity of service - suppliers**

If the Government considers it necessary to introduce measures to require service providers to continue to provide services for a 90 day period following administration, then this should be on the following basis. Firstly, that the administrators are able at the outset to guarantee to pay for the services on a day-to-day basis. In other words, instead of a single three month liability, the contractual provisions should be for day-to-day rates to be calculated on a pro-rata basis so that the administrators can terminate earlier if required, and need only guarantee on a day-to-day basis that the supplier will be paid. Secondly, we hope that this requirement is not applied retrospectively to supply agreements - these are often commercially sensitive arrangements and the financial consequences of early termination (because, for example, a supplier refuses to agree new terms) can be extensive.

Q32 What are your views on legislative changes requiring administrators to use the operational reserve only for operational expenses?

In our view, the concept of the operational reserve is misconceived. Most investment firms do not trade their own balance sheet or accept deposits, and so are currently required to keep either thirteen weeks' or six weeks' expenses as their minimum FSA capital requirement. The difference between the two depends upon the level of risk undertaken by the firm. The reason these numbers are used is that they may help to give the FSA a reasonable opportunity to arrange for the orderly wind-down of a business, while the firm's regulatory clients find a replacement firm. However, on a major insolvency, it could be that the claims against the firm exceed the operational reserve, so in practice these amounts may not afford the FSA that opportunity. It is not clear to us whether the Government is suggesting an additional operational reserve (which would then suffer from the same potential deficiencies) or whether the Government has not considered FSA's existing requirements in this regard. In our view, an additional operational reserve is unnecessary given FSA's existing capital requirements.

4. Chapter 4 - Reconciling And Returning Client Property

4.1 General

It may be true that the underlying existing protections for client money and assets are "generally fit for purpose" (paragraph 4.23 of the Paper). However the Court's decisions in relation to the Lehman Brothers ("**Lehmans**") insolvency have highlighted significant shortcomings in the drafting of the FSA's current rules on client money. The corresponding rules on client assets represent a somewhat unsatisfactory amalgam between material deriving from the EU Markets in Financial Instruments Directive and from the preceding UK regime, and are less easy to apply to intermediated securities, and to an international custody structure than is desirable. We are aware that the FSA proposes to consult imminently on changes to the relevant Sourcebook (CASS). We suggest that this process should not be confined to the specific issues raised in the Paper but should involve a thorough review of the rules as a whole. The first line of defence for client assets should be a set of rules which can be interpreted and applied without recourse to extensive guidance by the Courts.

That said, it is important that the regulatory response to the Lehmans problems does not result in imposing an over-engineered regime on smaller firms which have fewer complications.

We endorse the Government's comments in Chapter 8 of the Paper on the need for international convergence. In the context of internationally active institutions it is particularly unhelpful that there is no harmonisation, even within the EU, of the insolvency processes which apply to investment firms (which fall outside both the insurance and credit institution winding up directives and the general insolvency regulation).

4.2 Specific Responses

Q35 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?

We assume that the Government's concern on the first point relates to the holding of securities, rather than client money. The latter is of course subject a statutory trust under Sections 138 and 139 Financial Services and Markets Act 2000, and the treatment of shortfalls is dealt with in the FSA's client money regime. As mentioned above, we hope that the shortcomings in this regime identified in the Lehmans administration will be dealt with in the FSA's forthcoming consultation on CASS.

In the case of securities we agree that it is desirable to provide clarity on the treatment of shortfalls. There has been a tendency to be silent about the issue in contractual documentation, but a leading writer on custody law argues that there is an area of doubt, and that legislative or contractual provision is desirable:

> *"Where the securities of more than one client are commingled in fungible custody, there is some doubt that such clients have adequate proprietary rights in such securities. Such doubt could readily be removed by legislation. An alternative approach is contractual, establishing co-ownership rights in equity. Such wording should be included in the custody agreement as a matter of prudence."*

Any legislative solution would need to be carefully considered to avoid undue inflexibility and/or unintended consequences, and would also need to take account of the forthcoming EU Securities Directive. We concur with the concerns of both the Insolvency Committee and the Financial Committee in this regard. It may be preferable, in the interim, to adopt a regulatory solution and to require those holding client assets to set out contractually the nature of the client's interest in the assets and the way in which a shortfall will be dealt with.

The Lehmans administration has emphasised that the time at which clients' entitlements to client money are calculated can be of major importance, and that the CASS rules do not deal adequately with the issue. We agree that this should be sorted out. However we believe that a number of the difficulties arose from fluctuations in claims to a client money account which are less likely to arise in relation to securities held in custody, so there may be less need to deal with the issue in the custody context.

Q36 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?

We are not convinced that mandating warnings in agreements is either necessary or desirable for the following reasons:

(a) It seems to us that one of the better developments over the last few years has been to move away from requiring the mechanical inclusion of specific risk warnings in favour of a more general obligation on an investment firm to provide appropriate information about the risks of investment.

(b) There is a distinct risk that such warnings will be construed as some kind of acknowledgement on the part of the client that it does not have rights which might otherwise be available to it under the general law. For example a statement that "Your assets may not be protected" in specified circumstances may make it more difficult for the client to argue that as a matter of law they are.

We suggest that "clarity" is better served by ensuring that the client's contractual rights in relation to an omnibus account or rehypothecation are clearly and fully set out. If specific risk warnings are desirable at all then we suggest that placing them in the relevant agreement is not the best way of drawing them to the attention of the client. Such agreements are typically either read by the client's legal advisers (who should not need the warnings) or not read at all.

We agree with the Financial Law Committee's response to this question, in that the availability of designated named accounts should be left to the market since this involves matters of cost and settlement efficiency. In any case achieving segregation right through an international custody/sub-custody structure is likely to be difficult if not impossible to achieve.

Q39 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?

It is difficult to argue against such reporting requirements, though we must leave it to industry participants to comment on their practicality. So far as we can see the Government has not indicated what it means in this context by "systemic investment firms". We would be concerned if the requirement for daily reporting were to apply to the activities of a custodian providing, for example, custody of a portfolio of securities involving no derivatives, stock lending or leverage. (See also our general comments on the application of the Government's proposals at the beginning of this submission.)

Q40 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?

The proposals appear to be sensible.

Q41 Do you agree with the Government's support for increased audited disclosures by firms around client money and assets? Should Government require firms to make available audited client money and assets reports to clients?

The disclosures concerned, and the auditor's report, are addressed to the FSA, and it seems to us that it should be a matter for the FSA to determine what information it requires in order to supervise compliance with its rules.

We are not persuaded of the benefit of requiring disclosure of such reports to clients. If they are satisfactory they are of limited interest and if they are not it should be a matter for the FSA to take appropriate action.

Q42 Should the Authorities clarify the scope of FSA CF-29 and centralise CASS oversight under one individual?

The extension of the scope of CF 29 to include client assets as well as client money seems sensible. We can see the merit of requiring a single individual to take responsibility for oversight of all of a firm's client money and asset arrangements, but we question whether this will always be practicable, for example in a large firm where client money and assets may be held in a variety of different contexts in distinct parts of the organisation.

Moreover, we agree with the Financial Committee's response to this question in that the approved person undertaking CF 29 should carry sufficient gravitas with senior management in their firm and it should be emphasised that responsibility for the firm's compliance with CASS is that of the firm's senior management and not just the person undertaking CF 29.

Q44 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?

Clearly the establishment of mechanisms which would allow unencumbered client assets to be dealt with outside the administration or winding-up of the investment firm would enhance the protection of those assets. Whether this could be facilitated by changes to insolvency or other law is beyond the scope of our Committee's remit. From a regulatory standpoint we would not be in favour of imposing the use of such structures, at least until they have been more fully developed and tested in the market.

Q45 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?

We acknowledge the risks of permitting a firm to deposit client money with an affiliate, as set out in the Insolvency Committee submission. However, we doubt whether there should be a hard and fast rule against, or specific limits on, this. There may be circumstances where use of an associate is likely to present less risk than the use of another bank. We suggest that the issue is better dealt with by reinforcing, if necessary, existing CASS requirements in relation to the assessment and spreading of risk, coupled with a requirement to obtain client consent where an affiliate is to be used, or alternatively a legal opinion that local law will not prejudice the protections provided by CASS.

We suggest that the same approach should apply to the use of bank accounts in overseas jurisdictions. We are not clear how an absolute bar would work in cases where a client wishes to invest in a jurisdiction which gives rise to the "interoperability" issues which the Paper identifies.

Q46 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?

The proposal seems sensible in principle, though it will be difficult to apply the requirement to custodians (and sub-custodians) outside the UK. The letter might need to state either that there are no such set-off rights or liens or describe those which in fact exist. (The corresponding requirements in relation to client money (CASS 7.8) in effect apply only to money held in a UK bank.)

Q47 Should firms be required to have the capacity to separately pool client money relating to riskier activities?

We are not persuaded of the advantages of this proposal. The client money protections are intended to protect the client from credit risk, i.e. the insolvency of the investment firm itself. It does not appear to us that there is any necessary correlation between the investment risk of the transactions entered into and the risk of failure of the client money protections. Requiring such separate pooling appears to us to be unnecessary, and indeed it may be undesirable to the extent that it implies that client money relating to "riskier" activities may be less well protected. However we can see the merits of amending the client money rules so as to permit such separate pooling should the firm wish to offer it.

Q48 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?

We agree with the comments of the Insolvency Committee.

Q50 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 'futureproof' and do they have a limited negative impact?

We agree with the points made by the Financial Committee in its response to this question. We suspect that it is illusory to imagine that any proposed changes will be "futureproof". However we assume that any changes will largely be implemented through the medium of rules made by the FSA. These can and should be kept under review to ensure that they do not have a negative impact or impede the evolution of the market in the future.

Q51 Do you have any other views on the issue of client money and assets that you feel are important for the Government to consider?

See our general comments at the beginning of this section.

5. Chapter 5 - Providing Clear and Effective Support for Clients

Q52 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?

As indicated in our comments on Chapter 2 and for the reasons set out in the Insolvency Committee's and Financial Committee's responses to this question, we are sceptical about the value of having a CAT. However if it is decided to establish this structure, we suggest that it is limited to cases meeting defined criteria of complexity, e.g.:

(a) total value of client assets held;

(b) the extent to which they are encumbered;

(c) the general complexity of the issues.

This might be achieved simply by enabling the FSA to apply to the court for the appointment of a CAT in appropriate circumstances (as suggested in paragraph 5.10 of the Paper).

As regards the identity of the insolvency practitioner, this seems to us should be a matter for the FSA and/or the court to determine.

Q53 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?

We agree with the comments of the Insolvency Committee.

Q55 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?

We are not in favour of establishing a CAT for the reasons given in our comments on Chapter 2 and in the Insolvency Committee submission.

Q58 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?

We do not see the point of setting up a CAA. The purpose of this appears to be largely cosmetic and it seems to us a sad comment on our regulatory system if it requires the establishment of a separate agency to ensure that "focus is maintained" on client money and assets. It would surely be more cost-effective for the FSA to discharge any additional functions (including appointment of a CAT if desired). We agree with the Government's own analysis of the drawbacks of this proposal (paragraph 5.57 of the Paper) and do not see that there are any material countervailing advantages.

Q59 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?

We agree with the Insolvency Committee's comments.

6. Chapter 6 - Reconciling counterparty positions

Q65 What would be the advantages and disadvantages of extending Part 7 type protection to cover the default rules and trades of Multilateral Trading Facilities for all affected parties, including creditors? What other options should the Government consider?

In principle we see no issue with allowing MTFs, on a voluntary basis, to opt into Part 7 – albeit that the benefits would be relatively limited as set out in paragraph 6.22.

Further thought is required in relation to the issue of default rules and MTFs; MTFs operate under a variety of models, some utilise centralised clearing and others do not. The nature of default rules that are desirable (if any) and the level of protection under Part 7 needs to take into account business models, systems and contractual documentation. In this context, it might be helpful for Government to consider what would happen to outstanding trades executed on different types of MTF on the failure of a major participant. This would help to inform the appropriate policy decision.

Q69 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.

As a general matter cash trading of securities (debt securities as well as equities) is conducted over the counter, and generally on the same terms as those for equity securities. Whilst the settlement mechanics for debt securities vary from those for equity securities, the risks to counterparties associated with counterparty failure pre-settlement are broadly the same. In principle we therefore see no reason why default terms should not apply across all cash securities markets, if they are to be applied to equity markets.

Q70 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?

As indicated by the paper, the primary advantage of extending the Part 7 protections would be the certainty associated with the override of insolvency law in relation to covered trades. This benefits counterparties to those covered trades to the potential detriment of (other) unsecured creditors of the failed firm.

Whether that outcome is desirable is a policy matter outside the scope of this response. However, the extension of Part 7 protections might involve significant systems issues for CCPs and other market infrastructure providers who have default rules. It could also pose difficult questions for CCPs over the allocation of losses arising as between participants which are unrelated to the protection of the CCPs' own interests, and in circumstances where the CCP could have incentives to exercise discretions in favour of its members and to the detriment of non-members; this could require further regulation to mitigate the conflict inherent in the operation of the default rules in this situation.

Margin portability is a difficult area in this context; generalisations are difficult without more detailed proposals. We welcome the commitment to further explore portability issues.

Q71 Are there any other solutions the Government should be considering to promote margin portability?

No.

Q73 Do you agree there would be value in the introduction of an explicit requirement that CCPs offer facilities for members to segregate their business?

We do not believe that regulating CCPs to mandate offering of segregation is an appropriate or proportionate regulatory response to the issues raised in the chapter. For non-UK CCPs, segregation may be problematic in light of market norms and/or the domestic legal structure. For UK CCPs and other CCPs for which there are no obstacles to running segregation, a mandatory requirement to offer segregated clearing presents costs to the CCP with no necessary regulatory benefit, if it is left to investment firms whether to clear client business on a segregated basis. Accordingly, if the authorities are to seek to create incentives to segregated clearing (as to which see the following response), we believe that the correct regulatory lever should be a requirement at the level of the investment firm, not the CCP.

Q74 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?

It is our experience that, following the failure of Lehmans, clients are now keenly aware of the differences between segregated and unsegregated clearing models. The market is developing rapidly in this area to deal with the new focus taken by buy-side clients on counterparty risk management. While it is clear that there has been market failure demonstrated by the failure of many participants to understand their counterparty risk on clearing arrangements, it is clear that the market is adjusting to that failure. In light of this we do not believe that regulatory tools are needed to mandate segregated product offerings.

Q75 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.

Although not strictly raised by the Paper, we believe that greater focus should be given to the position of CCPs within the system. The growth in the number and variety of CCPs, and in regulatory incentives to their use, have the effect of increasing the likelihood of their failure, and potentially the negative externalities associated with that failure. In short we are concerned that CCPs have or will become a new class of too big to fail institution. We believe that active consideration should be given to how a CCP's failure would impact the UK markets and how that impact should be mitigated.

Q78 Do you believe that Government action is required to address contractual terms issues?

We do not believe that Government action is appropriate to deal with an essentially private matter between buy-side and sell-side firms, unless a demonstrable market failure exists which would be proportionately addressed by legislation or regulation. No case has been made that demonstrable market failure exists in this area; disputes between the buy and sell-sides over terms are typically questions of allocation of legal and commercial risk. Were those disputes to have systemic consequences, then a case could be made for legislative or regulatory intervention; we believe that they do not.

Q79 If you do believe regulation or legislation to address terms of business between investment firms and investment manager is required, which issues do you think are the highest priority? Which types of measures would best address them?

See our response to question 78.

7. Chapter 7 - Managing complex creditor positions

Q80 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?

We agree with the general principle that a market solution to any perceived issues with section 2(a)(iii) is preferable to regulatory or legislative intervention.

Q82 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?

Over-collateralisation and associated insolvency risk in the repo market is a commercial risk run by market participants. Mitigating those risks is a matter of improving risk management in firms and their clients. The government should not seek to legislate in this area. The FSA is looking at collateral management and should seek to improve regulated market participant's systems, but should not seek to impose detailed rules or requirements, given the different systems and structures employed by market participants.

8. Chapter 8 – Working towards cross border resolution

We agree with the Insolvency Committee's comments.

We would be delighted to discuss the above observations and suggestions with you. You may contact me on +44 (0)20 7295 3233 or by e-mail at margaret.chamberlain@traverssmith.com.

Yours faithfully

Margaret Ch

Margaret Chamberlain
Chair, CLLS Regulatory Law Committee

Members of the Committee:

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David Berman, Macfarlanes
Peter Bevan, Linklaters
Patrick Buckingham, Herbert Smith
John Crosthwait, Slaughter and May
Richard Everett, Lawrence Graham, LLP
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Depositary
And
Trustee
Association

16 March 2010

Alex White
Investment Banking Resolution
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Mr White,

RE: Establishing resolution arrangements for investment banks

The Depositary and Trustee Association (DATA) represents all depositaries and trustees of UK based authorised unit trusts and open-ended investment companies. At the end of December 2009, the members of DATA were responsible for safeguarding £480.8 billion of funds under management.

DATA welcomes the opportunity to comment on the abovementioned HMT consultation paper.

We had initially thought that the proposals applied only to investment banks. However, the paper regularly refers not just to investment banks but also to 'investment firms' which is defined (on page 160 of the consultation paper) extremely widely. It would appear to cover any legal entity regulated by the FSA as all entities providing investment services require FSA authorisation.

We believe that the scope of the proposals needs to be reviewed and defined with greater specificity in order that regulated entities know, with certainty, whether the proposals will cover them.

We do not believe that depositaries and trustees (collectively 'depositaries') of authorised unit trusts and open-ended investment companies should fall within the scope of such proposals. Depositaries act in a fiduciary capacity and do not carry out any proprietary trading.

A large proportion of the funds for which depositaries are appointed are UCITS schemes and the regulation of depositary activities flows from the UCITS Directive. This Directive requires depositaries, inter alia, to safe-keep the assets of the UCITS.

As fiduciaries, depositaries are required to keep fund assets separate from their own assets.

In addition for all authorised funds, there exist detailed FSA rules regarding the duties of depositaries in relation to fund assets. These duties are set out in the FSA's Collective Investment Schemes Sourcebook (COLL 6.6).

That Sourcebook also includes provisions which allow an authorised fund manager to appoint another person eligible to be a depositary in its place should a depositary cease to be authorised (COLL 6.5).

Where depositaries use the services of custodians, they will be clients of such custodians.

We should also like to draw your attention to two EU developments. You may be aware of the proposed EU Alternative Investment Fund Managers Directive. This contains detailed depositary provisions, including segregation requirements. In addition to this, the EU Commission has consulted upon the UCITS depositary function and we anticipate that the Commission will undertake further detailed work on depositary tasks, including the safekeeping of fund assets. It is vital that these European developments are taken into account in developing any UK depositary-related proposals. As we mention above, we believe that the resolution proposals should not apply to depositaries.

We hope that you find this input helpful. If you would like to discuss our response, or would find it helpful to meet with us to learn more about our activities and the regulation thereof, we should be more than happy to do so.

If you have any questions, please do not hesitate to contact me or our Company Secretary, Karen Bowie.

Yours sincerely

Kevin Tomlin

Kevin Tomlin
DATA Chairman

EUROPEAN REPO COUNCIL

Investment Banking Resolution
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

05 March 2010

Dear Sirs,

Response submission from the European Repo Council
Re: HM Treasury Consultation – "Establishing resolution arrangements for investment banks"

Introduction:

On behalf of the European Repo Council ("ERC") of the International Capital Market Association ("ICMA"), the purpose of this letter is to provide feedback concerning the repo specific aspects of HM Treasury's 16 December 2009 consultation paper – "Establishing resolution arrangements for investment banks".

The ERC was established by ICMA in December 1999, to represent the repo community in Europe. It is composed of practitioners in the repo field, who meet regularly to discuss market developments in order to ensure that practical day-to-day issues are fully understood and dealt with adequately. The repo market is one of the largest and most active sectors in today's money markets and, as evidenced in the recent market turmoil, plays a critical role in liquidity provision for the financial system. Repos are attractive as a monetary policy instrument because they carry a low credit risk while serving as a flexible instrument for liquidity management, which benefits the functioning of financial markets. In repo transactions securities are exchanged for cash with an agreement to repurchase the securities at a future date. The securities serve as collateral for what is effectively a cash loan and, conversely, the cash serves as collateral for a securities loan. Collateral is key to the proper functioning of repo markets. In what is truly an international market, the world's unique global documentation for repo transactions is the GMRA (the most prevalent version being GMRA 2000[1]).

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[1] The Global Master Repurchase Agreement (GMRA) 2000 is the most extensively used cross border repo master agreement and has reduced the risks associated with previously poorly documented repo transactions.

Scope of Review:

Whilst there are many interesting issues discussed in this HM Treasury consultation paper, the ERC is going to restrict its focus to those aspects that bear directly on repo.

The pertinent sections of the consultation paper are:

7.3 Based on discussions with the Advisory Panel, the Government believes that the extent of value destroyed for unsecured creditors during the insolvency of an investment firm is broadly commensurate with that involved in the failure of other types of firms. However, there are some discrete factors that may need to be addressed, which may otherwise cause the insolvent estate, and therefore its unsecured creditors, to face significant losses. These include:

- uncertainty around the timing of counterparty terminations and close out valuations in derivatives agreements. The Government is of the view that the market should move towards incorporating a defined period for termination within these contracts. It will monitor developments closely and may consider applying bar dates for termination of derivatives contracts, should it be considered necessary.
- difficulties faced by administrators in managing trading book risk exposures of a failed investment firm. The Government proposes to provide administrators with a range of options to engage risk managers and focus on risk management under administration, through a resource centre as outlined below.
- challenges around managing repo-market close-outs effectively.

Repo-market close-outs

7.24 During the financial crisis, large banks and investment firms found it difficult to depend on repo financing to meet their obligations due to increasing repo rates and "haircuts" in the repo markets and the refusal by lenders to accept some kinds of securities as collateral. Repo counterparties required higher haircuts or margins from firms facing liquidity problems to account for uncertainty related to the value of collateral.

7.25 In terms of the value recovered for general creditors of an investment firm, there may be a case for policy action to deal with value trapped with clearing banks or repo counterparties if they hold on to 'excess' collateral from a defaulting investment firm.

7.26 Repo collateral is held by either a tri-party clearing bank, or directly by the lending counterparty if there is no third-party clearing. If the borrowing investment firm is unable to repay the cash to the clearing bank or cash lender, then the counterparty would need to sell the collateral to recover its cash. The repo counterparty would then need to return any cash over and above what was owed to it by the investment firm (i.e. 'excess' collateral or cash) back to the defaulting investment firm.

7.27 However, if the counterparty finds it difficult to sell the collateral or there is significant disagreement between the counterparty and administrators on close-out values, it may result in the counterparty holding on to the excess collateral if any, which means that the insolvent investment firm's estate could be losing value. The value of repo market collateral can potentially be significant in the case of investment firms and the excess held with the repo counterparty has the potential to affect the returns to unsecured creditors substantially. The Government is considering the extent to which this issue needs to be addressed, and what possible steps may need to be taken.

Question 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?

ERC Feedback:

The ERC has carefully deliberated the content of these particular paragraphs, together with the associated question 82, and is pleased to put forward its considered response.

Whilst the ERC recognizes the validity of the comments in paragraph 7.24, it is important to appreciate that the evolution of market terms is a natural function of changed market conditions. Thus the changes in terms resulted from, rather than led to, the downturn of conditions outside the repo market. Also, notwithstanding that some firms may then have found it harder to depend on repo funding, it is the case that the beneficial structure of collateralised lending, inherent in repo financing, became even more significant. Overall repo funding in fact became more important as a source of funding, as providers of unsecured funding withdrew from risk taking.

The Bank of England, in common with many other central banks, utilises repo transactions to guide monetary policy implementation. As a part of the terms and conditions of these facilities provisions are put in place that allow the receiver of collateral to request protection against adverse changes in the value of the underlying, a technique used by market participants and central banks alike. This built-in mechanism allows the cash lender to proactively protect the value of the cash. In the turmoil this technique of additional margin calls was used by many participants to protect against the decrease of value of the received collateral (securities) and in extreme circumstances can lead to haircuts up to 100% (i.e. making the use of the collateral in question uneconomical for the cash borrower). This extreme rejection of collateral can be most effectively managed where the terms and conditions of the bilateral agreement, under which it has been advanced, contemplate the possibility of alternative actions (such as its withdrawal and replacement). This has the benefit for the cash lender that he is able to receive new collateral allowing the outstanding trades to be honored. It has also a benefit for the cash taker, who can try to find other sources of funding for the collateral rejected by the initial counterparty. It would be imprudent for the collateral to remain on the books of the cash lender with a haircut of 100%. In case of a default the residual value of these bonds would normally retain some market value and as such put the liquidator of the collateral (i.e. the cash lender) in an abnormally comfortable position. In any case, without the above described technique repo transactions would simply become similar in profile to the use of unsecured cash – with the consequent significant capital requirements provided for by the Basle 2 regime.

The repo product has accordingly been developed subject to carefully designed legal provisions. These are substantively standardised through the GMRA, which provides a leading example of the sort of market consistent documentation that the European Financial Markets Lawyers Group[2] now seeks to further promote.

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[2] http://www.efmlg.org/home.htm

For instance, in relation to repo transactions governed by the GMRA 2000, where a party to the GMRA has a net exposure in respect of the other party it may by notice to the other party require the other party to make a margin transfer to it (any, or a combination of, cash or securities) equal to that exposure. In the scenario envisaged above, where the value of the received collateral has decreased to a point where it has become uneconomical to use for the cash borrower, parties to the GMRA may agree not to apply the margin maintenance provisions of the GMRA but to reprice transactions (GMRA 2000, para 4(j)) or to eliminate an exposure by adjusting transactions (GMRA 2000, para 4(k)). The adjustment method terminates the original transaction and the parties enter into a replacement transaction with new securities provided as collateral, whose value is substantially equal to the repurchase price under the original transaction.

Paragraphs 7.25 – 7.27 address the question of collateral and the concern that excess collateral may be trapped in the hands of repo creditors to the detriment of unsecured creditors. The ERC underscore that the purpose of taking collateral is one of prudent risk management. In so doing experienced judgments are made regarding how much collateral, of what type, needs to be held at any point in time. This will be reflective of the credit exposure faced and the applicable market conditions. Market practices in this regard reflect the recommendations for a "Best Practice Guide to Repo Margining", as issued by the European Repo Committee (the ERC's governing board) in 2005[3]. It is important to note that in case there is a default scenario, it will only be once the whole portfolio is sold off that a determination can be made as to whether or not there is in fact any over-collateralisation. Accordingly it is only at this point that it becomes possible to return an excess for the benefit of unsecured creditors – to release any collateral sooner would be imprudent.

In the context of the GMRA 2000, the occurrence of an event of default has the effect of accelerating outstanding transactions and turning delivery obligations in respect of securities to cash sums based on default market value, then applying set off. A net sum will become due in favour of the party with the higher valuation for its transactions. The acceleration and conversion of obligations serves to reduce the risk of negative price movements in purchased securities following a default. The default market value is calculated by the non defaulting party in accordance with established principles which consider actual sale or purchase prices, market value quotations or fair market value as determined by the non defaulting party acting in good faith (GMRA 2000 para 10(e)). As this legal provision makes clear, it is important to recognize that as part of the unwinding process, firms are required to act in good faith and therefore they cannot sell assets at fire-sale prices – rather they will discharge the sale of collateral in a responsible manner. This aspect is the crucial one, as it is in this way that any excess value, that transpires to have been held by repo creditors, is protected for the benefit of unsecured creditors.

The ERC would also highlight that the effect of the HM Treasury proposal would be to transfer risk from the unsecured market to the secured market which would not create the right incentives, particularly as several other officially sponsored steps being taken in response to the crisis emphasise that responsible market participants should seek to adequately collateralise their credit exposures. The ERC firmly believe that, as a matter of well established legal principle, value should not go to unsecured creditors over the interests of secured creditors.

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[3] https://www.icmagroup.org/ICMAGroup/files/75/7525d290-bff4-4054-8ec8-bfc351ac053b.pdf

There is however an important need to consider the risks faced by unsecured creditors and, where there is a mixture of secured and unsecured financing, an important tool in this regard is an encumbrance ratio. One possibility could be to require the publishing of encumbrance ratios, which would give more transparency to unsecured creditors; and it is possible to contemplate that limits should be created regarding how high a ratio is permissible (perhaps differentiated by the borrower's type). Such concepts are of course already found in many privately negotiated unsecured financing contracts. Of course this is just one element of credit risk management, in the context of which all banks have unsecured lending limits to counterparties (both other banks and corporates). These limits are part of an overall risk profile vis a vis counterparties that will include lines for all product exposures with those clients.

The ERC believes that the interests of all parties are best served if provisions applicable to repos are as efficient and effective as possible. Limiting repo creditors' security rights imposes more risk, increasing financing costs and thereby harming the economic position of end-users, be they market participants or central banks conducting their monetary policy operations. Moreover, the financial crisis highlighted the global scale of markets and their interconnectivity. The collateral analysis provided in the latest ICMA European repo market survey (conducted in June 2009[4]) shows that collateral is not limited to European countries. Over 20% of collateral is from outside the European Union, evidencing that ERC members trade with counterparties on a global scale. Therefore any steps to be taken need to be considered and consistent at an international level. Nothing should be done that could lead to an undermining of confidence in the current legally robust framework for repos, since that could actually precipitate a worse crisis in the daily management of liquidity.

The ERC appreciate the valuable contribution made by HM Treasury's examination of the issues articulated in this consultation paper and would like to thank HM Treasury for its careful consideration of the repo specific points made in this response. The ERC remains at your disposal to discuss any of the above points.

Yours faithfully,

Godfried De Vidts
Chairman
European Repo Council

CC : ICMA European Repo Committee

4 https://www.icmagroup.org/ICMAGroup/files/3f/3fb33acf-f14c-4469-a3dc-c101c9c74f59.pdf

Mr Alex White
Investment Banking Resolution
HM Treasury
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19 March 2010

Ref:

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By post and email: alex.white@hmtreasury.gsi.gov.uk

Dear Mr White

Establishing resolution arrangements for investment banks – response from Ernst & Young LLP

INTRODUCTION

1. Ernst & Young LLP welcomes the opportunity to review and comment on the consultation paper entitled *Establishing resolution arrangements for investment banks* ("the Consultation Paper").

Our interest

2. Ernst & Young is one of the largest global professional services organisations. We provide audit, accounting, tax, corporate finance and other business advisory services. Our UK activities are supervised by the Institute of Chartered Accountants in England & Wales, with further supervision over certain parts of our business by the FRC and FSA.

3. Our interests in the Consultation Paper are twofold:

    - Our client base is diverse and represents most sectors and industries, including financial services. As auditors and business advisors we have seen the wide-ranging effects of the financial crisis on most sectors and industries.

    - We are a large business in the UK with over 9,500 employees and partners. Not only do all of our people have a personal interest in the issues raised in the consultation, we are dependent on a fully functioning (retail and investment) banking system in the UK.

4. We are generally supportive of the proposals made. However, there are a few points we wish to highlight to help provide a context for our responses to your questions (included in the attached appendix).

OVERALL OBSERVATIONS

5. In the aftermath of the financial crisis it is important that lessons are learnt, especially in the way investment bank resolutions are managed. To this end we believe there is scope for new and revised measures to be put in place, in the interest of creditors, counterparties and clients. However, we know from experience just how important it is to recognise and consider the different and sometimes diametrically opposite expectations of all three parties.

6. The challenges covered by this consultation are not unique to the UK – and many investment businesses operate globally through their various business and management lines. We urge UK authorities to work with international counterparts towards more consistent and coherent approaches to resolution.

Potential solutions and issues

7. A bank entering administration will suffer greater losses as the markets become aware that the bank is trading with the sole purpose of closing out its positions. For example, counterparties are more inclined to contest and/or delay an agreed close-out valuation, if they suspect that the other side is about to become insolvent. This buys the counterparty more time, with the possibility of simply “walking away” or valuing outstanding contracts at a price which is more favourable to them. The lack of certainty this creates does not serve the interests of creditors or clients, and it can have a destabilising effect on the wider market.

Business Resolution Officer (BRO) and Resolution Plans

8. An important means to address this issue is the proposed introduction of the BRO. In our opinion this person should be able to clarify up front the structure and risks of a bank’s business, as he/she develops a resolution plan. This should help the bank to expedite solutions to future issues more efficiently and effectively. Moreover, this could help to discover and resolve vulnerabilities in the business, removing potential problems before they arise or become critical.

9. This would not only contribute to an individual bank’s resilience, it might also support the mitigation of wider systemic risks. This could be achieved if every bank introduces a BRO who produces an effective plan. Their collective output could help to address market-wide issues and risks, with the net effect of developing and preserving confidence in London’s markets.

Benign markets and Master Agreements

10. If, however, a bank goes into administration, we support proposals which would allow markets to be opened outside normal trading hours. This would enable contract prices to be fixed, creating more certainty for the bank as it seeks to close out its open contracts in a relatively benign environment.

11. The issue of close-out valuation disputes might be resolved with a revision to the OTC Master Agreements, where the use of hypothetical close-out valuations could be introduced (e.g., calculated as a mean value over a stated period of time) with a deadline for the termination of contracts. This could be reinforced with the introduction of bar dates, as proposed by the government. We believe these measures would provide an effective way to establish a cut-off date for counterparty valuations and claims, enabling the administrator to move forward and establish a net position for the bank's assets.

Client Asset Trustee (CAT)

12. However, arrangements for resolving counterparty issues will not necessarily address the concerns of the bank's clients. This situation has prompted the government to propose the introduction of a CAT. Its purpose is to offer some form of protection for clients, whilst ensuring they are properly informed on matters related to the administration (including legal rights etc).

13. That said, the entity best placed to do this already exists in the form of the administrator. Also, if there is any rehypothecation, asset pledge and/or margining, the CAT will need to interact and hold an agreement with the bank's estate, (i.e., the administrator) to get a clear position on the rights and claims of the estate. This means, in effect, that information provided to clients by the CAT would be a "second-hand" account of the situation, whereas the administrator has a first-hand account of this information which it can share with clients directly, at relatively little or no extra cost. So we do not see the need for the introduction of CATs.

14. However, we do see a need to improve client education, so they are *fully aware* of the *wider range of risks* they take, including the likely consequences if their bank goes into administration. To this end we encourage the government and regulators to seek ways to increase client awareness and understanding, even for the larger and more sophisticated clients. This is because most clients understand the risks involved with rehypothecation and the use of omnibus accounts , but they do not always understand the full implications of these arrangements (e.g., issues associated with the timing of asset transfers) when a bank goes into administration.

15. In addition to improved education, clients should have the option of requesting (and banks should have the right to offer) a designated custody account which holds assets that are not rehypothecated. However, this will be operationally expensive for the banks and therefore likely to be more expensive for the client, in terms of fees charged. It will also, of course, not guarantee a refund of all those monies in the event of a wind down, a point we would expect to see communicated clearly and succinctly to all clients.

Costs

16. Finally, it is important to consider the costs of the new measures proposed by the government. For example, designing and setting up resolution plans may require external advisers and consultants. This will also include the recruitment (search, selection, induction and training) of specialists to take ownership of the plans (audit and maintenance) and the means necessary to implement them. Also, in a distress situation, all

resources will be stretched which means that external advisers will be required to help oversee and implement the plan.

17. Additional costs might also arise if the Business Information Pack (BIP) is introduced as a separate stand-alone document. We regard the BIP as an integral part of the resolution plan, in effect a front-end which helps to sign post the location of data, records, key personnel etc. Therefore, if the BIP and plan are treated separately, it could make the plan difficult to implement and it would be a challenge to keep both documents in sync with each other.

18. Similarly, the proposal to introduce a virtual resource centre has its drawbacks which might create more problems than it solves. For example, there is the cost and complexity associated with maintaining the resource, comprised from disparate entities and/or individuals in separate locations. There is also the challenge faced by different experts brought together to resolve an issue, when they are unfamiliar which each others' methods and approaches. But with the right level of funding, administrators can always access relevant expertise from the professional services market, as and when it is required.

CONCLUSION

The proposals acknowledge that a bank in crisis stands a better chance of resolving its issues if there is greater certainty: i.e., planning, resource, pricing, communication and awareness. We applaud the Treasury for undertaking this initiative, and hope that the introduction of the proposed measures will provide additional benefits, especially in terms of raising greater awareness amongst clients of the implications of an investment bank insolvency.

We are grateful to HM Treasury for publishing the Consultation Paper. We hope that you have found our comments helpful. If you would find it useful, relevant members of our firm are available to discuss further any of the points we have raised. Please contact John Liver (020 7951 0843) or Maggie Mills (020 7951 9802).

We wish you every success with the rest of the consultation process and encourage you to publish all non-confidential responses to the Consultation Paper in due course. We look forward to reading the results.

For the avoidance of doubt, none of the comments set out in this letter are intended to be confidential.

Yours faithfully

John R. Liver.

John R Liver
Partner

APPENDIX

RESPONSE TO SPECIFIC QUESTIONS

Chapter 1 - Introduction

Q1. Do you have any comments on the proposed definitions of investment firm for the purposes of this work?

We have no comments to make on the proposed definitions.

Chapter 2 - Enabling an orderly resolution

Q2. Do you agree with the Government's proposals for special administration objectives and associated policy measures? Are there any supporting levers not considered in this document that would be critical for the effective functioning of the special objectives?

We agree. In our view it is essential that the duties of administrators are clarified and prioritised with the relevant authorities, if one of the overriding objectives is to maintain financial stability in the event of an investment bank insolvency.

We are not aware of any oversights in the document, although more emphasis could be placed on various practical measures to help achieve administration objectives. In particular, the revision of Master Agreements and greater controls on TSO flagging and Repo contracts, might help to counter the activities of some lenders and counterparties who can adversely affect the creditors of a struggling bank, whilst undermining confidence in the wider market.

Q3. 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?

We agree. Holding administrators to account, in terms of their fiduciary responsibilities to all stakeholders, should be comparable to the responsibilities of company directors, including a limitation on liabilities.

Q4. 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?

We agree. The personal liability of administrators should not extend beyond the estate and their legal responsibilities, unless they are negligent. They are bound by laws and regulations which govern their responsibilities and actions, so it is only right that liability should be confined to these parameters.

Q5. 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?

We agree with the government's intentions. However, in practical terms (e.g., interpretation of contracts and evaluations) creditors, clients and counterparties will expect due process and adequate time to seek counsel and comment on issues. Therefore, we are not sure if the court process can be fast-tracked in the way suggested.

We are generally less enthusiastic about the introduction of more legislation, although regulatory intervention can be effective. However, we have a preference for market-led solutions and best practice, which is why we believe that changes in Master Agreements (to help improve the clarity and consistency of OTC contracts) with the introduction of bar dates (to limit the duration of time over which a close-out valuation can be made) should help to improve certainty and obviate the need for the intervention of the courts. But of course administrators can always seek direction from the courts in a relatively short time frame, if a particular set of circumstances require urgent attention.

Q6. 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?

The government could put a cap on administrator liability. However, the current regime pre-empts the need for modifications in the way suggested, because administrators (as agents of the company) are effectively directors of the company and accordingly face the same liabilities (and limitations of liability) as the original company directors (pre-administration).

Q7. 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 financial stability? What specific modifications could the Government consider applying?

We do not agree. Directors are already required to act in the interests of the company's creditors, under company law and regulation. Therefore, we question the need for this enablement by the government, because directors already have a mandate to undertake plans to protect their creditors.

However, we would have no objection to the government introducing a special defence for directors in circumstances where they might be required to implement pre-resolution measures.

Q8. 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 described in Box 2A?

Yes we agree. It is important that a special administration regime synchronises with the Banking Act 2009, but special consideration would need to be given to the time required for an administrator to work within an FSCS arrangement e.g., ensuring that depositors either transfer their accounts to other institutions, or claim compensation from the FSCS within in a "reasonable" timeframe.

Q9. Is there a case for considering 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?

There is the potential, under certain circumstances, for a market to be opened outside normal trading hours to allow open contracts to be closed in a relatively benign environment, preceding an administration. This, in effect, could provide a special means of financial management by netting down OTC gross positions, to help serve the interests of creditors by limiting and simplifying exposures.

However, there are likely to be issues with counterparty valuations, if any of those parties sit on the losing side of a trade. In this scenario they are likely to contest and/or delay an agreed close-out valuation, if they suspect that the other side is about to go into administration. This buys the counterparty more time, with the possibility of simply "walking away" or valuing outstanding contracts at a more favourable price than might otherwise have been the case. This makes a clear case for the introduction of bar dates.

Q10. 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

The overall costs to market participants will be moderate in our view. This is because short-term costs associated with intra-day support will be negligible, as the options to provide this level of support will be remote, for reasons explained in response to Q9.

The cost of recovering client monies should be charged against the client money pool, rather than being levied against a bank's creditors. This could be used as a buffer/top up deposit, which remains unused (un-invested) unless there is a bank failure.

However, we expect there to be more costs related to the proposed changes to processes which exist outside the administration regime. For example, the introduction of living wills and BROs will have set up, maintenance and support costs.

Q11. 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.

We believe that market participants will appreciate clear statements on regulatory actions which have been taken, and legal decisions which have been made. This could be coordinated with a clearing house protocol, which pre-determines the timing, sequence and level of information they disclose to the markets on: i) what steps will be taken to close out positions; ii) progress on the close-out by exchange; and iii) the extent (if any) to which clearing houses have to resort to their guarantee funds (over and above initial margins) to close out a defaulter's positions.

Q12. The Government considers the costs to market participants of a resource centre providing best practice guidance to administrators, and plans for coordinated 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

If other elements of the proposed regime work effectively (e.g., provision of adequate funding, business recovery plans, fully trained and resourced business recovery officers) with the backing and ongoing vigilance of the regulators, we do not believe that a resource centre will be necessary. However, if there are extenuating circumstances, specific expertise can be brought in externally from "non-conflicted" specialists in the market.

We neither agree nor disagree with the estimated costs of the proposed resource centre. This is because there is no comparable cost we can use to make an estimate, and there are so many variables to consider. For example, costs will be associated with set-up and maintenance, depth and breadth of expertise and experts, and potential take-up of the service.

Q13. 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?

We agree, to the extent that there would need to be a coordinated approach from regulators in different countries, to accommodate potential conflicts between the UK and local home-country regimes. However, we expect this will be difficult to achieve because each country's administration rules and principles will be determined by local jurisdictions. We also believe that the option to opt in or remain outside the UK regime could lead to regulatory arbitrage, with the costs and complexities that confers on market participants.

Q14. Are there any other specific issues in relation to cross-border investment firms, not considered here or in Chapter 8, that need to be addressed?

The issues raised in our earlier responses apply here. In particular, the divergence of national regimes and markets (legal, regulatory, trading, clearing and settlement) means that any national regime (including but not limited to the UK) may not be able to remedy all of the problems encountered by the creditors and clients of cross-border firms that default. Some of these challenges have not been covered this consultation. In many respects they are unavoidable consequences of international trading which no single jurisdiction can resolve. We would encourage the UK authorities to work with counterparts towards international consistency and coherence.

Q15. The Government welcomes views on the extent to which the package of measures proposed in Chapters 2 and 3 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?

We believe that a Special Resolution Regime (as per the Banking Act 2009) would be a natural extension of the arrangements already proposed in this consultation, and it could make them more effective.

If this additional step was taken by the government, it could help to provide more certainty and confidence in the markets if/when another investment bank gets into serious difficulty. It would also reflect more closely and consistently the regime for retail banks, which would be especially beneficial in cases where an institution in difficulty has both retail and investment operations. This would help to reduce the cost and complexities of the same institution having to follow two similar but separate regimes.

Chapter 3 - Requiring firms to manage for failure

Q16. Do you have views on the coverage or detail of the BRO's responsibilities as outlined here? Are these consistent or compatible with existing templates for the corporate governance structure of firms?

Consideration needs to be given to the structure and complexity of investment banks, when looking at the responsibilities of the BROs. For example, boards at group level will have issues and concerns that differ from the boards of specific entities within the same group. Accordingly, the type and level of risks will vary, and this needs to be considered when a BRO is appointed as part of a firm's wider corporate governance approach. In our view the role of the BRO will extend the current corporate governance scope and remit.

Q17. Do you agree with the basic policy of establishing a role for business resolution

officers 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?

We agree with the basic policy for establishing a BRO. We see this as a high-level project management role for someone who understands in detail the risks and issues associated with investment banking. However, consideration needs to be given as to how the BRO role will interface with the CRO and the roles of other directors when implementing a resolution plan.

Q18. 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?

It is unlikely that the role of BRO will succeed in our opinion, unless it is made clear from the outset that the role comes under the Approved Persons regime, and it is in addition to a board member's pre-existing duties. Clarity is required in this regard, so it is clear to the board how the BRO dovetails with the CRO and other directors/roles.

Q19. 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

At this stage it is very difficult to say, with any degree of certainty, how much additional time (and therefore cost) would be required of a board director who takes on the role of BRO. In many respects it will depend on the size, complexity and activities of the firm, but we have no doubt that it will increase costs to some degree. At the very least, even if the role is taken up by the CFO or CRO, the role will require more junior staff to provide administrative support, in the process of setting up and maintaining a resolution plan.

That said, the existence of the BRO role will help to clarify, up front, the structure and risks of a firm's business which could have a bearing if/when that business gets into serious difficulties. Moreover, this could help to discover vulnerabilities in a business before it gets into difficulty, helping to inform improvements and improve overall effectiveness. This would not only contribute to an individual firm's resolution plan, it might also support the mitigation of wider systemic risks as all firms would have BROs whose collective outputs should help to address market-wide issues and risks. This could make a significant contribution towards the augmentation of confidence in London's markets.

Q20. Do you agree that investment firm resolution plans can consist of internal actions followed by market-facing actions as proposed above?

We agree with these actions, both internal and external. However, there may be circumstances where the sequence and timing of actions will vary, as specific issues arise and require an immediate response. As information becomes more available and transparent - as a consequence of implementing resolution plans - firms and regulators should be better placed to agree on time-critical decisions more quickly, to improve the effectiveness of the overall outcome and likelihood of a successful resolution.

Q21. What are the obstacles to implementing investment firm resolution plans as suggested in this paper? What policies could the Government consider to address these, if any?

External obstacles might include the behavior of counterparties and reactions from other market participants. For example, counterparties might under-value and/or delay close-out valuations if they stand to make a loss. This could make it difficult for the administrator to reach a net trading position. A more prosaic problem, but equally damaging, could be the fallout from trades which are tagged incorrectly by the bank, creating added difficulty when trades go to clearing and settlement.

Internal obstacles might include the attitude of senior executives in the bank. Some might resist the development of comprehensive resolution plans, because they might unearth and/or amplify anomalies in a bank's processes and procedures, or highlight some of the more unpalatable (long-term) risks. The planning process could also raise the profile of weaknesses and threats at a divisional or departmental level, which some business units and their leaders might prefer not to highlight. Other issues might arise if the roles and responsibilities between COO, CRO, and BRO are unclear and/or conflict, indicating a lack of adequate resolution planning by the board.

Q22. 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 outlined here, do you agree with the suggested costs for the prime brokerage business?

In many respects our response to this question is reflected in our reply to Q19. The one-off cost (and annual costs) to a prime brokerage business will depend on the size and complexity of the individual firm. This challenge will be compounded further by the specific lines of business conducted by the brokerage, together with bespoke procedures and operations designed to support that business.

Q23. What resources do you expect the entire investment banking business of the firm to spend on resolution plan implementation? Costs would include those related to: (a) designing and setting up resolution plans in collaboration with the FSA; (b) the ongoing audit and update of resolution plans and their inclusion in the firm's corporate governance activities; and (c) the additional resources required to implement resolution plans in a distress situation, if any.

The costs could be significant in each of the areas identified. For example, designing and setting up resolution plans may require external advisers and consultants. This will also include the recruitment (search, selection, induction and training) of specialists to take ownership of the plans (audit and maintenance) and the means necessary to implement them. Also, in a distress situation, all resources will be stretched which means that external advisers will be required to help oversee and implement the plan.

Additional costs might also arise if the Business Information Pack (BIP) is introduced as a separate stand-alone document. We regard the BIP as an integral part of the resolution plan, in effect a front-end which helps to sign post the location of data, records, key personnel etc. Therefore, if the BIP and plan are treated separately, it could make the plan difficult to implement and it would be a challenge to keep both documents in sync with each other.

Similarly, the proposal to introduce a virtual resource centre has its drawbacks which might create more problems than it solves. For example, there is the cost and complexity associated with maintaining the resource, comprised from disparate entities and/or individuals in separate locations. There is also the challenge faced by different experts brought together to resolve an issue, when they are unfamiliar which each others' methods and approaches. But with the right level of funding, administrators can always access relevant expertise from the professional services market, as and when it is required.

Q24. Do you agree that business information packs will be useful to administrators and will fulfil the Government's objectives for a managed wind-down of investment firms?

We regard the business information pack (BIP) as an integral part of the resolution plan, in effect a front-end which helps to sign post the location of data, records, key personnel etc.

Therefore, the BIP and plan need to be treated as one and the same, to ensure they remain in sync with each other, otherwise the BIP could be less useful to administrators.

Q25. 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.

As in the case of resolution plans, there may be ongoing benefits to the investment banking business from having in place continually updated BIPs, but these are not included here.

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

Please refer to our response to Q22.

Q26. 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.

Please refer to our reply Q23. The issues associated with the cost of establishing and maintaining a resolution plan can also apply to the Business Information Pack in our opinion.

Q27. The Government would welcome views on what incentives and disincentives are likely to be effective and whether there are any concerns with the ones suggested above.

We have no concerns. However, there will need to be a mix of regulatory sanctions (disincentives), and the commercial reality (incentive) of wishing to keep a business running effectively during a resolution. Apart from considering the interests of creditors and clients, this will obviously include the commercial realisation of bonuses and other reward schemes which directors and staff will have vested in the firm.

Q28. 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?

We agree that key staff need to be identified up front, and they ought to be aware of their role, should the firm ever get into difficulties. This should be reflected in their contracts, although most will already be on three or six months' notice. That said, it might help if additional incentives are offered to key staff during a resolution, over above any other rewards they may have vested in the firm, to encourage the effective performance of their roles at a time of crisis.

Q29. What do you consider would be an appropriate measure to ensure that the fees that suppliers charge post-insolvency are not inordinately high? Do you believe the Government can take specific action in this regard?

Suppliers could be obliged to exclude insolvency break clauses from their contracts, and a commitment to provide the same level and quality of goods and services (at the same prices as before) as long as they are paid under the usual terms of business in an insolvency process. We are not sure what the government can do in this regard, but we believe there is scope for some form of regulatory solution/intervention.

Q30. 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 renegotiating 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. The cost implications of associated policy measures such as an operational reserve for the payment of staff and essential services, the BIPs and BRO are examined in the relevant policy sections.

Do you agree with the cost estimates suggested above, for contractual provisions for key staff and suppliers? What are your views on the incremental costs of: (i) renegotiating 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?

We neither agree nor disagree. Our response is similar to replies made earlier on issues related to cost.

The cost estimates will depend on the size and complexity of the bank, which will determine the range of services it buys from suppliers. In addition, the location, size and status of those suppliers will also have a bearing on the cost of contract renegotiation, as will the fees charged by the professional advisers (e.g., influenced by their size, profile and ranking).

Q31. What alternative policy tools 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?

We are not aware of any specific policy tools - in addition to the introduction of resolution plans - to provide for the continuity of essential services. We are also unaware of any resolution issues which could impact on the competitiveness of UK companies.

The process of administration, and need to keep key personnel "locked in" during transition, might extend to six months, ensuring essential services are maintained throughout the process. However, in a growing number of sectors, there are UK companies that provide "run-off" services, to ensure clients continue to receive business-critical services for longer periods of time, so they are not put at an immediate competitive disadvantage.

Q32. What are your views on legislative changes requiring administrators to use the operational reserve only for operational expenses?

It is essential that funds are made available to enable the administrator to fulfil its duties. But since these duties are already set out within the current legal framework, we see no need to change existing legislation.

Q33. 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 the suggested cost estimates above? 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?

We neither agree nor disagree with the proposed estimate. There are so many variables to consider when making cost estimates, like those referenced in our response to Q19.

Q34. Do you have any views about the operational reserve proposed in Chapter 3?

It is essential that funds are made available to enable the administrator to fulfil its duties. But since these duties are already set out within the current legal framework, we see no need to change existing arrangements.

Chapter 4 - Reconciling and returning client property

Q35. 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?

We welcome any initiative by the government which helps to provide clarity on regulatory matters, especially ones like this. However, we understand that the FSA is about to consult on various "gaps in the rules" (e.g., the rules are silent about situations where client money is placed temporarily into a house account, but the bank fails before the money is transferred to a segregated client account, as per the original client agreement).

The FSA should be in a position to address these gaps, but in the meantime "tracing rules" can be applied (based on a recent court judgment) by clients seeking to recover their money placed temporarily into omnibus accounts at the time of a bank default. In our view this is a matter of clarifying existing regulation, rather than introducing more/tougher legislation.

Q36. 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?

We agree. There is a general education process required, even for the larger and more sophisticated clients. This is because most clients understand the risks involved with rehypothecation and the use of omnibus accounts , but they do not always understand the full implications (e.g., issues associated with the timing of asset transfers) when a bank goes into administration.

In response to the second part of the question, clients should have the option of requesting (and firm should have the right to offer) a designated custody account which holds assets that are not rehypothecated. However, this will be operationally expensive for the banks and therefore likely to be more expensive for the client, in terms of fees charged. It will also, of course, not guarantee a refund of all those monies in the event of a wind down – a point we would expect to see communicated clearly and succinctly to all clients.

Q37. Do you agree with the Government's aim to encourage clarity in contractual agreements? If so, how is this best achieved?

Yes we agree. We believe this can be achieved for master and client agreements, with protections mandated by the FSA for standardised investment products, services and portfolios. This should help to provide extra clarity for 80% of clients. For the remaining 20% who use more unique products, there is still scope to standardise certain elements of the underlying contracts (e.g., termination clauses, pricing and jurisdiction).

Q38. 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.

There are various implications which need to be taken in consideration when legal warnings are added to documents in the way described. These could add further costs to the wider industry and markets. For this reason we believe an estimated one-off cost, and an attempt to envisage future benefits, will be inaccurate and highly subjective.

For example, there may be expectations on the part of some clients to have these warnings communicated to them by various means, at different times and at various levels of detail. There could also be expectations that reasonable steps are taken by a bank to ensure its clients fully understand the significance of these warnings, in both general and personal terms. In addition, the content of the warning might need to be revised at different times, to reflect future changes in legislation and regulation. Finally, there is the challenge of ensuring that reasonable steps are taken to ensure the meaning and significance of these warnings are not lost in translation, for foreign clients and/or overseas markets.

Q39. 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?

We disagree. Most investment banks communicate statements to all of their counterparties online, and clients are generally aware of their day-to-day positions. In addition, where clients pledge collateral, the title transfer is clearly documented and reported to the clients, regardless of what type of account is used to hold the collateral (e.g., house custody account). For these reasons, we are not sure whether the government's proposal to increase reporting requirements is necessary.

If there is an issue to address, it is the effectiveness of the information already reported to clients, especially in regards to the banks use of collateral. We say this because we are aware of circumstances where clients believe their counterparty risk is limited to a proportion of their collateral, pledged against an amount of their rehypothecated assets. However, the totality of collateral may be at risk, with any day-to-day excess unavailable to the client because it is pooled together with collateral from other clients.

There are exceptions though, when designated client accounts are used. However, these are relatively expensive to manage, which is reflected in higher fees charged to clients. For this reason most clients tend not to use them, mistakenly assuming (in some cases) that their risk is proportionate to those assets which are invested by the bank. We therefore believe there is an opportunity for the government to encourage improvements in the way clients are educated about the full extent of the risks they take.

Q40. 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?

We disagree. Full records are already kept to enable banks to reconcile trade and settlement date records with custody accounts. In most cases the variance in timing between trade and settlement (up to five days) requires nothing less.

In our experience most trades are settled, and trades which are matched and confirmed up to and including the date when a bank fails, should also move through to their pre-determined settlement days. This is because banks' systems produce records of expected postings for each trading day, and these trades are recorded (as if settled) until reports from the custodians come through at the end of the day (to include failed trades). At this point the difference between expected and actual trades is reconciled, and settlement is confirmed. Therefore, we believe the level of record keeping is appropriate and does not require increasing.

Q41. Do you agree with the Government's support for increased audited disclosures by

firms around client money and assets? Should Government require firms to make available audited client money and assets reports to clients?

We agree in principle. However, we would be interested to know whether, or to what extent, clients will fully understand and make use of these extra disclosures. We say this because there will be occasions, in the normal course of business, when client account processing anomalies will be spotted and reconciled. It is not clear whether these events should prompt a matter of emphasis letter, or other less formal reports. However, we believe there is a risk that clients might be unduly alarmed on matters which might not have any material significance to them, and the consequences of this could damage trust and confidence in the markets.

Q42. Should the Authorities clarify the scope of FSA CF-29 and centralise CASS oversight under one individual?

Yes, we agree that there should be a designated person (approved by the FSA) at a senior level in the bank who takes responsibility for client positions.

Q43. 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.

We neither agree nor disagree. The estimated costs in this question need to be looked at with a great deal of caution. This is because there will be so many variables to consider, not least the time and effort required to build a new reporting system or enhance an existing one.

For example, there will be related costs (associated with internal controls, internal audit and risk monitoring) to ensure the system is reliable and the people who manage it fully competent. In addition, the auditing of these disclosures will increase auditor liability and resource requirements. This will have a bearing on the overall cost of the audit, relative to the size and complexity of a given bank, which at this stage is difficult to estimate with any degree of certainty.

Given our comments in response to Q40, and our views expressed here, the cost- benefit analysis may be potentially misleading in our opinion, notwithstanding the good intentions which lie behind it.

Q44. 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?

If this proposal can work in practice, we believe the government should support it. We take this view because even though the use of a Special Purpose Vehicle (SPV) might position client assets one step away from the estate of a bank, the SPV is still linked to the bank for various purposes (e.g., processing of dividend payments, trade reconciliations and settlement).

The SPV will also need to be a regulated entity and managed properly (presumably by the bank) because it holds clients assets. Therefore, the contractual relationship between the bank and SPV will determine whether or to what extent the SPV can be ring-fenced from administrators, in the event of the bank going into administration.

Q45. 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?

We believe there is merit in this proposal, because although it might appear as though risks are being spread, there is the potential of a countervailing "ripple effect", as more client accounts and custodian accounts could be affected in the event of a bank's collapse. This could also lead to situations where client assets are moved by several banks - unbeknown to each other - to the same or smaller number of third parties. This would inadvertently concentrate risk, and the implications if this entity collapsed could be severe for the markets.

Q46. Should firms that manage client assets be required to obtain letters from custodians stating that there are no setoff and liens over client assets in respect of liabilities owed in a principal capacity by the firm?

We agree that there should be no set-off and liens over client assets in these circumstances. The banks should also ensure they have a written acknowledgement to this effect from each custodian.

Q47. Should firms be required to have the capacity to separately pool client money relating to riskier activities?

It is not clear to us how this arrangement can provide any further protection for clients in general, or a bank's creditors in particular. The cash is still held by the bank, regardless of which client pool it is held in, and how much margin is paid to or owed by the client.

Q48. 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?

We agree. A bar date would be useful because it would allow the administrator to get monies flowing in an administration earlier than might otherwise be the case. It would also help to provide more certainty and clarity over information flows. For these reasons we believe it would be helpful if the government legislated for this requirement.

Clients' rights could be protected by the Liquidation Rules, which require the administrator to place advertisements and take reasonable steps to alert creditors. The bar date would have to be promulgated in the same way, to ensure everyone had the same (and appropriate level of notice).

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 over liens. Additionally there could be other 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; and**
- **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.

We neither agree nor disagree. We assume that these costs only refer to back office administration, rather than overall commercial costs of funding a business. This makes it difficult to comment on the proposed benefits relative to their cost. Similarly, the costs will vary significantly depending on the size and complexity of the bank, so we feel unable to offer our own estimates for the purpose of this analysis.

Q50. 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 'futureproof' and do they have a limited negative impact?

We believe that the proposals in relation to client money and assets, would allow sufficient flexibility in the way described. However, the innovative nature of the 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 (new rules). Therefore we remain unconvinced that any measures adopted by the regulatory regime, however well thought out, can be made future-proof. The only constant, as we see it, is the need for the FSA to provide "clarity" in the way it explains its rules and the risks they address, for all clients and creditors large and small.

Q51. Do you have any other views on the issue of client money and assets that you feel are important for the Government to consider?

No other views to add.

Chapter 5 - Providing clear and effective support for clients

Q52. 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?

We disagree. If the aims of the CAT are to provide some form of protection for clients, whilst ensuring they are properly informed on matters related to the administration (including legal rights etc), the entity best placed to do this already exists in the form of the administrator. Also, if there is any form of rehypothecation, asset pledge and/or margining, the CAT will need to interact and hold an agreement with the estate, (i.e., the administrator) to get a clear position on the rights and claims of the estate. This means, in effect, that the information would have to be sought by the CAT as second-hand content, whereas the administrator has a first-hand account of this information, which it can share with clients at relatively little or no extra cost.

Q53. 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?

The CAT would need to be substituted as the trustee, if client assets are to be vested in it, because these assets have to be held under trust. However, in terms of the establishment of a CAT, neither approach would be particularly advantageous in our view. This is because whatever form the CAT takes, it could not expedite client matters more quickly or as cost-effectively as the administrator, for reasons outlined in our response to Q52.

Q54. Should the costs of the CAT be funded from the client money and assets of the firm, or from the insolvent estate?

The CAT would have to be funded by the client monies, otherwise you would have to make a cross-subsidisation, which would require new public policy to allow unsecured creditors to subsidise clients.

Q55. 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?

No, we do not agree with this proposal, for reasons outlined in response to Q52 and Q53.

Q56. 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.

We disagree. A faster return of client money would come from better record keeping and the introduction of a bar date, rather than the CAT per se. As explained in our response to Q52, the CAT is unlikely to expedite the return of client monies, and the existence of the CAT would have to be funded by the clients (see Q55.). For these reasons we do not believe that the CAT is a cost-effective proposition for clients.

Q57. 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?

We agree, if the government insists on moving forward with the CAT. It would make sense if someone already familiar with the system was encouraged to perform the role. Of course, we would expect that person to be subject to the usual information requirements and liabilities, whilst also accountable to the courts.

Q58. 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?

We do not agree with the proposal in support of the CAA, to the extent that the FSA already has the people, policies and processes necessary to operate CATs, assuming that the government wishes to proceed with its proposal for these trustees.

Q59. 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?

In principle we see no obstacle to prevent the FSA from sitting on the client committee, in the capacity of a regulator. However, we are not sure what the FSA could achieve by sitting on the creditors' committee, since the procedures relating to the creditors' interests are prescribed by law. There are no points of debate or a strategy which a regulator could review, challenge and/or seek to revise. The process of a wind up is unidirectional, and its outcome inevitable.

Q60. 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?

Yes we agree. All firms regulated by the FSA should fall within the jurisdiction of the CAA.

Q61. 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?

Overall we believe that costs will rise on this matter, not least because new costs will be created for the set-up and management of the CAA. Also, if the CAT is introduced, research will be required to establish best working practices, as well as training and additional ongoing support for members of the CAA as they review and perform supervisory duties.

Q62. Do you have any other views on the establishment of a CAT or CAA that the Government should consider?

Our overall views on the proposed CAT and CAA are covered in our responses to questions Q52 to Q61.

Chapter 6 - Reconciling counterparty positions

Q63. 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 to address incorrect TSO flagging, 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.

We agree with your assumption, to the extent that regulatory intervention could help to improve TSO flagging, but this depends on what form of intervention is envisaged. For example, it would be impractical and too costly for the FSA, or other regulatory body, to supervise or perhaps inspect TSO flagging. Similarly, if it was found that a particular bank had recorded a high proportion of inaccurate TSO records, and a financial penalty or some other form of sanction was made against it, we doubt whether this would provide much of a deterrence for the rest of the market. Other issues associated with this would include the setting of thresholds e.g., How many incorrect TSO records would be tolerated? What period of time would be covered in a regulatory inspection or review?

We believe that a more cost effective solution might be for the regulators to provide guidance and training on this matter. Responsibility for this could perhaps be placed under the aegis of the CRO or some other executive, so it falls more clearly within the scope of a bank's corporate governance.

Q64. What action should market participants take to address incorrect TSO flagging? Do you believe regulatory action to address the issue of TSO flagging is needed?

Please refer to our response to Q63.

Q65. What would be the advantages and disadvantages of extending Part 7 type protection to cover the default rules and trades of Multilateral Trading Facilities for all affected parties, including creditors? What other options should the Government consider?

From a practitioner's perspective, a default close-out should provide more certainty and clarity, which should therefore help to achieve more quickly a net position for the failing bank and its counterparties. However, it remains debatable as to whether, or to what extent, this might be welcomed by those counterparties for whom a close-out results in a loss, which could otherwise have been delayed or possibly reduced through a protracted valuation and discussion with the administrator. Of course, in these circumstances the creditors will stand to gain, and it is their interests that must come to the fore in an administration process.

In situations where open positions are created on exchanges, the daily novation of these trades to a central counterparty removes the potential issues related to close-out pricing. In this regard, transferring open positions in OTC contracts (which would have to be limited to the "plain vanilla" variety) to a clearing house so they can be novated in the same way, might be beneficial to the markets in general and creditors in particular.

Q66. 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?

We agree that the AFME protocol is a "sufficient solution", as long as its flexibility and adaptability does not come into conflict with the obligations and duties undertaken by parties involved with an administration. We share the view of others, that the issues it seeks to address can only be resolved through market solutions, rather than legal or regulatory measures. But this means that practitioners need to support and adhere to the protocol, to make it work effectively and ensure it develops to meet future requirements.

Q67. 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?

Putting the AFME protocol on a regulatory footing might place it in conflict with existing legislation. This might cause complexity and confusion at a time when individual practitioners involved in an administration can least afford distractions like these. More generally, we take the view that a protocol ceases to exist when it falls under regulation. For example, any changes to the protocol would have to be reflected in the regulation that underpins it, which would require due process, compromising its flexibility and adaptability.

Q68. 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?

When a bank, or any other entity, enters into administration no statutory netting takes place immediately. However, if matters develop into a liquidation, there is a statutory requirement to conduct an offset to create a net position. That said, under these circumstances, it might be more advantageous to the estate and creditors if a mechanism is used to calculate the gross value of OTC cash equity trades. This places 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.

Q69. 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.

Default terms and guidance have generally existed for the purpose of covering the default of a bank's client, rather than covering the circumstances that arise from a bank default. So we recommend that regulatory guidance is provided for both sides, before references to specific classes of assets are included. However, when this task is undertaken we expect that the range and commonality of asset classes will become more apparent, which will help to inform the government's decision on which assets should be taken into consideration in relation to an insolvency.

Q70. 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?

Extending the protections of Part7, in the way described, would serve the interests of the underlying clients if it is their express wish for their trades to be cleared and settled by another clearing member. Similarly, the counterparties should not have an issue with this either, because regardless of the size and volume of trades conducted, they will novate overnight to the central counterparty and clear in the usual way.

From an administrator's perspective this arrangement should be acceptable, on the proviso that client assets have not been rehypothecated, and all fees and amounts due are paid. However, there may be an issue with creditors in certain circumstances. For example, a transfer of trades could potentially represent (or be perceived as) a permanent shift in "throughput" to another competing clearing member, which might undermine the administrator's efforts to sell (at a fair price) the entity it is currently managing. This could give rise to expensive claims by the creditors, which could have an unsettling and costly affect on the clearing house, exchange(s) and markets in general.

Q71. Are there any other solutions the Government should be considering to promote margin portability?

We are not currently aware of any other solutions the government could bring to this situation. However, we prefer market solutions over legislative or regulatory intervention, and in this respect we believe that the clearing houses are probably best placed to do this, to achieve the best outcome. An area which might be of particular interests is the transfer of trades between the clearing members of different exchanges, where contract offsets and related services already exist.

Q72. Initial 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 also 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.

We concur with the findings of your initial discussions with stakeholders. In particular, we agree with the government's assumption of having the client and house accounts separated. However, we expect there to be no offsets (of amounts due to the investment bank) expect through the house positions.

However, the estimated cost per investment bank will obviously vary, depending on the size, complexity and risk appetites of each bank. So we welcome HM Treasury's intention to conduct more research into this area with the aim of refining its estimates.

Q73. Do you agree there would be value in the introduction of an explicit requirement that CCPs offer facilities for members to segregate their business?

If the requirement to segregate is made explicit, this should provide added assurance and confidence for clients. However, this arrangement is likely to increase costs, so the markets will need to weigh up the balance between higher costs (or increased fees) and the provision of more assurance for clients. We expect that at different times greater assurance will be more of an issue than the cost of doing business, and vice versa. So market conditions will probably influence the attractiveness or otherwise of segregated client accounts.

Q74. 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?

Please refer to our responses to Qs 72 and 73.

Q75. 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.

We are not aware of any specific issues, in addition to those raised in this consultation.

Q76. Does EUI's proposed approach to settlement provide greater predictability and are there ways it could be improved?

The concept of predictability is a good idea, because it means that clients can ensure that only those trades they wish to see settled will actually get settled. However, these clients might wish to cherry pick between counterparties. For example, clients might have onward commitments to sell or lend stock, and only a small selection of counterparties will have this stock available to sell. This could put the insolvent entity at a disadvantage because it would be frozen out of CREST, under the EUI's proposed approach. Its clients would therefore be unable to make these trading and settlement choices.

Q77. Have the key consequences of EUI's proposal to increase certainty of settlement been identified correctly and do the benefits for the market as a whole of the proposed revised approach outweigh these consequences?

We believe that the key consequences of the EUI's proposal have been identified, but they may have been understated. In our view the pros and cons of the proposal are very finely balanced.

We say this because it seems likely that an insolvent entity would struggle to fulfill its trading and, if relevant, clearing obligations if it wished to settle existing trades. This is because the time required to re-input trades into CREST (which had been deleted earlier at the moment the firm entered administration) could lead to variations in the valuation of the original trades/contracts, leading to potential disputes with clients and counterparties. This could also breach exchange and/or clearing house rules, resulting in a member default. If this happened the firm's (member's) clients could, ads a consequence, be exposed to greater loses. Similarly, creditor's losses might increase because the administrator might find it more difficult to sell a firm which also happens to be in default.

Q78. Do you believe that Government action is required to address contractual terms issues?

Since the buy and sell-side representatives have both agreed to explore ways in which issues on contractual terms can be resolved more effectively, we encourage the government to play a watching brief on this for the time being. We believe that a market solution is the preferable way forward, and accordingly intervention by the government at this early stage could be counterproductive.

Q79. If you do believe regulation or legislation to address terms of business between investment firms and investment manager is required, which issues do you think are the highest priority? Which types of measures would best address them?

Please refer to our previous response to Q 78.

Chapter 7 – Managing complex creditor positions

Q80. 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?

We agree, to the extent that a market solution must respect the freedom of contract and allow a reasonable period of time for a non-defaulting counterparty to close its open positions, at a value and time acceptable to both parties (administrator and solvent counterparty). However, the current ISDA Master Agreement does not obligate the counterparty to do this. This means, in effect, that the counterparty can leave the creditors of the defaulting firm to bare losses which, in the normal course of business, the counterparty would have had to face.

We believe this could be regarded as unfair practice. Therefore, we suggest that the Agreement should be revised, perhaps requiring the use of hypothetical close-out valuations, created as a mean value over a stated period of time, with a deadline for the termination of contracts. If, after a trial period, the market is unwilling to accept the revised Agreement, we would like to see the Bar Date concept extended, together with regulatory back-up that does not require recourse to the courts.

Q81. Do you agree with the proposal for a resource centre to aid administrators of investment firms?

The idea of introducing a resource centre is laudable. However, in practical terms, we believe that the administrators' experience, expertise and contacts (with other services providers) will more than suffice to meet the challenges of an investment bank resolution.

Q82. 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?

In general terms, we believe that market solutions are more preferable to legislative or regulatory interventions. This is particularly the case with repo close-outs, because regulatory intervention can impact on the freedom of contract and therefore impinge on the freedom of the markets. For this reason, we believe that guidance could be produced to help develop best practice in the negotiation of repo financing deals, to include resolution clauses. These could perhaps include upper limits on potential margin rates and "haircuts" when collateral is first deposited. This would offer some form of protection for borrowers in the event of them facing liquidity issues, although it would probably limit the range of collateral they could deposit and increase the cost of the financing.

Q83. In relation to the areas listed here, 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?

We do not have any major concerns to add to those already identified in this Chapter. We also take the view that on balance the mitigations outlined in section 7.28 address the main negative externalities.

Q84. 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 here and which the Government should consider?

We have nothing specific to add, other than the need for the government to consider the outcome from "too much" regulatory intervention. This could affect the dynamics of the UK's markets (e.g., a perceived erosion of protections for lenders or trading counterparties of banks under administration, could increase the cost and/or scarcity of financing). One possible outcome from this could be a move by banks to trade and/or finance their operations outside the UK, which could place their creditors at a greater risk of loss in the event of a default.

Annex C – Consultation Stage Impact Assessment

Q85. Do you have any suggestions which could help improve the Government's proposed quantification strategy? If so, please specify what these are.

We have no suggestions to make at this time.

Q86. Are you able to provide an estimate of the financial impact of any delays or issues with LBIE's resolution process on your firm, as a counterparty, client and/ or creditor? If so, please provide an estimate for losses in the areas below, and what caused them. Please give the Government an idea of your firm's size.

- **For counterparties, please provide any information about the cost to your firm of uncertainty about what would happen to trades at trading, clearing and settlement, inability to hedge exposures, and the need to double-margin.**

- **For clients, please provide any information on resources allocated to sorting out an investment bank failure, and any cost from inability to use capital and assets tied up in the investment firm.**

- **For unsecured creditors, please provide any information about losses caused by destruction of the intrinsic value of the firm's estate as a result of events occurring after the administration.**

This question is more relevant for investment banks, rather than an administrator of a bank. Also, any estimates we could provide would, for the most part, be hypothetical and therefore possibly misleading. For these reasons we have declined to answer this question.

Q87. Are you able to provide any information which might help the Government quantify the ongoing or broader ‘ripple’ impacts of issues with the resolution process of a failing investment firm as described above? If so, please provide an estimate.

Please see our response above.

Q88. Are you able to provide any information that would help the Government to assess the loss of confidence caused by any problems with the resolution process itself, as described above? If so, could you please provide an estimate of costs associated with the loss of confidence?

Please see our response above.

Q89. By what percentage do you believe the proposals in this document might reduce any issues associated with the resolution process for an investment firm? Do you agree that, as a minimum, the overall package of measures proposed has potential to reduce any difficulties by 50%?

Please see our response above.

euroclear

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London, 16 March 2010

Establishing Resolution Arrangements for Investment Banks
Response from Euroclear UK & Ireland Limited

Dear Alex,

This response to the above consultation document issued by HM Treasury in December 2009 is provided on behalf of Euroclear UK & Ireland Limited ("EUI") which, as you will be aware, operates the CREST system, the UK's securities settlement system. We have commented on HM Treasury's proposals in this area in the past (and contributed through working groups to those proposals), and we are grateful for the opportunity to provide further input.

In this response we do not address all the questions raised in the document; we have focussed our response on those areas of particular interest to EUI or in relation to which EUI has useful knowledge and experience to contribute.

Question 2: do you agree with the Government's proposals for special administration objectives and associated policy measures? Are there any supporting levers not considered in this document that would be critical for the effective functioning of the special objectives?

EUI welcomes the introduction of special administration objectives and in particular welcomes the fact that one of the proposed new objectives will require administrators to ensure timely engagement with market infrastructure bodies and the authorities. EUI has noted the difficulties that can be caused in dealing with a large-scale default situation by a lack of communication from insolvency office-holders.

Question 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.

EUI welcomes these proposals to improve communication with the market in the event of the insolvency of an investment bank. These are issues which EUI has raised on a number of occassions with the Authorities. There is clearly potential for instability in financial markets where there is a lack of proper communication. In markets where there are (as in the UK) an ever-increasing number of trading, clearing and settlement venues the difficulties of information dissemination may become acute. For these reasons we would urge the Government to bear in mind that the Authorities need to ensure that not only do they communicate information about their own proposed actions promptly, but they take steps to ensure that information flows between market participants are properly co-ordinated. Given the diversity of participants in the trading, clearing and settlement space it seems inevitable that it will fall to the Authorities to take on this co-ordination role.

The Lehmans events also highlighted that information sources for the Authorities (and consequently market infrastructure) were incomplete. As an example, obtaining accurate and timely information regarding the actual administration order was difficult in the critical intial hours. The Authorities should consider how improvements can be made in the information they receive and pass on in this area.

EUI has in the past played an important role in provision of information to the Authorities and other infrastructaure bodies in the market, including in investment firm insolvency situations. It is important, however, that the Authorities recognise that recent developments in the post-trading field are likely to reduce the visibility EUI has of market events. In particular, the continuing growth (both before and after the Lehmans events) of internalisation of settlement within firms and increased netting of trades outside the CREST system are likely to mean that much activity is not reflected by movement in the CREST system (ie no actual transfer of legal title). EUI will therefore not be in a position to provide information in relation to it (and related issues such as the timing and nature of finality of settlement may not be clear). The Tripartite Authorities need to factor these developments into their communication planning and to give urgent consideration to ways in which they might deal with any difficulties in procuring prompt, accurate and standardised information.

Question 31: what alternative policy tools could be considered to ensure continuity of essential service and key staff post-insolvency? Are there any likely impacts on the competitive position of UK firms from this proposal?

EUI agrees with the Government's view that the withdrawal of services by essential service providers in the event of a firm's insolvency could create problems in the administration. We note that the Government considers that infrastructure providers for trading, clearing and settlement are within the category of service providers with which firms should be required to put in place "insolvency proof contracts" (i.e. contracts which provide that their services should be available to administrators for at least 90 days of the administration process).

EUI would like to clarify that in fact it does not cease to provide services to insolvent CREST members. On receiving notice of a CREST member's insolvency EUI generally would disable all relevant CREST participants immediately (for reasons including that it would be highly undesirable to permit insolvent participants to continue effecting transactions in the CREST system). Participants will only be re-enabled, following discussions with the insolvency official, on satisfaction of certain conditions (see CREST Rule 13). EUI has proposed a revised approach to handling pending settlement instructions relating to insolvent members which is described in Chapter 6 of the consultation document. However, to date EUI has worked hard to assist regulators, administrators and the wider market to deal with defaults; it has not simply ceased to provider services to insolvent members.

It should be recognised that certain service providers (like EUI) are, by reason of their regulatory position and/or importance in the market, likely to be effectively obliged to go on providing services in some degree to firms despite their insolvency. Further consideration should be given as to how their right to recover payment for ongoing services may best be protected; without such protection it is not realistic to expect those service providers not under the same degree of obligation to enter into contracts requiring them to continue to provide services in an insolvency. This leads us to our response to question 32, dealing with the proposed obligation on firms to maintain an operational reserve to meet payments to service providers.

Consideration should also be given to dependencies in relation to continued service provision, which firms would need to take into accout in reviewing and attempting to provide for continued essential service provision. As an example, CREST participation would also be dependant on the investment firm maintaining a secure network link with the CREST system (this link is provided by independent providers such as SWIFT and BT). Additionally, CREST participants require the continued cooperation and provision of liquidity by their CREST settlement bank.

Question 32: what are your views on legislative changes requiring administrators to use the operational reserve only for operational expenses?

We support a legislative obligation on administrators to use the operational reserve only for operational expenses. It will be necessary to provide more detail as to exactly which services are deemed to be essential post-insolvency in order to determine which costs will fall within the definition of "operational expenses". We have some additional concerns with regard to the proposals regarding the operational reserve, set out below.

We note that the Government envisages that the assets comprising the operational reserve would remain in the legal and beneficial ownership of the firm which will be required to assume that it cannot use it prior to insolvency. It is not clear to us how (or if) the requirement not to use the operational reserve prior to insolvency is to be enforced. In times of financial stress, unless the firm's obligation not to use the assets prior to insolvency is set out in a rigorously policed and enforced regulatory provision, there is a risk that it may be disregarded.

We also query whether it can safely be assumed that the costs of services provided to the insolvent firm will necessarily and in all cases be considered "expenses properly incurred by the administrator in performing his functions in the administration of the company" and will therefore take priority over other claims in the insolvency. This point is not fully explored in the consultation document and service providers may well require a higher degree of assurance that they will be paid for their services before agreeing to enter contractual obligations to provide services post-insolvency. There may be little incentive for insolvent entities to pay such expenses promptly, and little prospect of service providers taking recovery action in respect of unpaid expenses. Further assurance, for example in the form of monthly payments in advance on account and confirmation by insolvency officers that they consider ongoing provision as expenese in the administration, may be needed.

Even if the costs of essential services can clearly and in all cases be regarded as expenses of the administration the claims of secured creditors will still take priority and this may not give service providers much comfort that they will be paid promptly. It is neither fair nor reasonable to expect service providers to continue in that role post-insolvency with only a vague and distant prospect of proving their claims to remuneration after the claims of secured creditors have been settled.

Finally, we note the reference (at paragraph 3.75 of the consultation document) to the fact that securities or cash accounts in which operational reserve is held should be free of liens and rights of set-off, other than possibly in relation to, for example, the fees of the securities depository or settlement system in which the securities are held. Given that depositories and settlement systems are highly likely to be in a position whereby they have to go on providing services post-insolvency, there is certainly a case for looking at how their interests may be protected.

So far as EUI is concerned, however, regard must be had to the arrangements whereby CREST settlement banks increase the intra-day credit granted to CREST members who grant them a floating charge over the securities in their CREST accounts. Provided the deed granting the security is lodged with EUI (and some other conditions are met) the settlement bank can realise its security by the fast-track procedure laid down in the CREST Manual if the CREST member becomes insolvent. The ability to realise its security in this way is a very important means by which a settlement bank covers its exposure to a CREST member.

Granting a lien or other form of security to EUI or any other service provider over securities in a CREST account has the potential to undermine these arrangements and thereby undermine the payment system operated by CREST. We suggest therefore that this is not a feasible way to protect the interests of EUI or any other service provider.

Question 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 client's entitlement to their assets should be calculated?

We note the discussion of the international measures taken or in prospect with implications in this area, in particular the UNIDROIT Convention and the proposed Securities Law Directive. It seems to us that it is important to ensure that the provisions to be agreed in the Securities Law Directive are consistent with those already agreed in the UNIDROIT Convention, in this area and more generally. We understand the Government's desire to provide clarity in this area but there are dangers inherent in attempting to legislate while the European position has yet to be agreed; it would be difficult for firms to change their arrangements to comply with new domestic requirements, only to have to change them again to comply with new requirements originating in EU legislation. Timing and coordination of approaches requires consideration to avoid successive waves of revised approaches.

Question 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?

We note that the European Commission is planning to legislate in this area in the proposed Securities Law Directive. It will be important to ensure that parallel initiatives do not cause conflicting requirements.

Question 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?

Question 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?

Question 41: do you agree with the Government's support for increased audited disclosures by firms around client money and assets? Should Government require firms to make available audited client money and assets reports to clients?

We note the Government's intention to increase transparency and promote a "look through" principle whereby investors have visibility over assets held throughout the custody chain. We assume that the Government's intention is to apply enhanced regulatory requirements in this area to investment firms which are firms regulated by the FSA under FSMA.

In this regard it is important to note that the CREST system provides a facility for a higher degree of client asset segregation than is commonly the case at present. Many CREST participants operate accounts in the CREST system in which they keep securities on behalf of a large number of different clients. It is, however, a simple matter for a CREST participant to establish a number of different sub-accounts in which assets of clients could be kept. EUI is happy to assist its participants insofar as it can to achieve a higher degree of client asset segregation if this is what the Government or the market demands. EUI is able to provide its participants with information relating to settlement activities if required, subject to applicable fees.

Question 64: what action should market participants take to address incorrect TSO flagging? Do you believe regulatory action to address the issue of TSO flagging is needed?

The difficulties created by incorrect TSO flagging are well understood by the Government and discussed in the consultation document. We note the Government's preliminary finding to the effect that regulatory action to address the issue would involve a negligible cost to firms.

In EUI's view, it is essential that transactions are accurately flagged with the relevant TSO. Given the importance of the issue, in relation to accuracy of records, SDRT assessment, as well as wider regulatory functions, we suggest that it would be appropriate to take regulatory action to ensure the issue is properly addressed by firms. EUI looks forward to discussing feedback on this issue with HM Treasury in due course.

Question 65: what would be the advantages and disadvantages of extending Part 7-type protection to cover the default rules and trades of MTFs for all affected parties, including creditors? What other options should the Government consider?

We see potential advantages for market participants in extending Part 7 protection to default rules of MTFs, not least in the certainty it would provide that positions reached as a result of the application of those rules would not be subject to challenge by the administrator. We suggest, however, that any default rules of MTFs which are to be so protected should be well-drafted, clear and comprehensive so that EUI and other affected parties can understand how their own approach to default will interact with them. Minimum standards or requirements as to content would be the best way to ensure such rules were sufficiently comprehensive. We also note that if default rules remain optional for MTFs then a substantial amount of uncertainty in the market about how to react to a large-scale default situation will remain (and the benefits of extending Part 7 to MTFs may well not arise). Further consideration should therefore be given to requiring MTFs to put in place default rules in the same way as regulated markets.

We should make one further point. In our response to HM Treasury's consultation of May 2009 on developing effective resolution arrangements for investment banks we pointed out the need to consider, in addition to the extension of Part 7-type protection to default rules of MTFs, the imposition of measures to ensure that MTFs co-operate with other market infrastructure bodies in the event of another large-scale default. Recognised Investment Exchanges and Recognised Clearing Houses have well-established regulatory co-operation obligations, relationships and procedures which enable communication to take place in response to significant events; in the increasingly fragmented environment thought needs to be given as to how new players in the trading and post-trading environments can be encouraged to develop similar channels of communication, and the role that the regulator itself should play in facilitating information flows. We are somewhat disappointed that this point has not been addressed in this consultation document and we hope that the Government and the FSA will consider it over the coming months.

Question 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?

Question 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 such a step?

EUI considers it essential that OTC cash equity trades are subject to clear terms to deal with default situations. We welcome the AFME Protocol as a helpful step forward in addressing the market uncertainty that resulted from the lack of default terms governing OTC trades in the aftermath of the collapse of Lehmans. To be effective, it is clearly important that the Protocol is broadly adopted. We support the Government's approach of assessing the success of this market-lead initiative over the coming months and welcome the fact that it stands ready to put in place a regulatory or statutory solution in the event that the initiative fails.

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

Question 77: have the key consequences of EUI's proposal to increase certainty of settlement been identified correctly and do the benefits for the market as a whole of the proposed revised approach outweigh these consequences?

We welcome the fact that the Government is consulting the market on the proposed manner of dealing with pending settlement instructions in the CREST system on insolvency of a participant, on the basis of EUI's proposal in this area. EUI looks forward to discussing with HM Treasury the consultation responses received. We would ask that we be kept informed of developments in the Government's policy in this area, so that we may continue to provide necessary input and ensure that proposed changes are workable for CREST participants and EUI. In particular, further consideration will need to be given in due course regarding necessary legislative changes required for EUI to implement the proposal.

Yours sincerely,

pp

Richard Crews

Deputy Chief Executive Officer

Euroclear UK & Ireland Limited

EVERSHEDS

Establishing Resolution Arrangements for Investment Banks

Response to Chapter 4 of the consultation dated December 2009

by Eversheds LLP

Eversheds LLP is one of the larges law firms in the United Kingdom. It acts for a large number of Fund Managers, and represents more authorised funds than any other firm in the country.

This response is limited to chapter 4 of the consultation, "Reconciling and Returning Client Property".

As a preliminary comment, we make the point that any changes to the rules for clients assets and client money should apply to all authorised firms, not just investment banks.

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?*

The judgement in Lehman v CRC has provided clarity, but we think that it would be as well for the Government to put the matter beyond doubt, particularly if the rules change.

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?*

We see no point in putting warnings in relation to omnibus accounts if it is not possible to take alternative arrangements. It is more important that the arrangements are such that a warning becomes unnecessary.

Incidentally, paragraph 4.35 refers to the possibility of a client enjoying the sole beneficial interest in a client account designated only to that particular client. In fact, under the current FSA rules, such an account provides no benefit at all, because on an insolvency all client accounts are pooled. This is a flaw in the current regime.

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

The aim is highly desirable, but is unlikely to be achieved whilst the investment banks are mainly American.

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?*

We are doubtful as to the practical benefit of increased reporting. For a start, the aim must be to achieve a situation where investment firms do not become insolvent, and so the circumstance for the use of the reported information disappears. More specifically, such reporting will inevitably increase costs, and will in any case only be as good as the information reported. The decision in *Lehman v CRC* has shown that it is the application of the rules as much as the rules themselves which are decisive in protecting (or, in that case, not protecting) client assets.

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?*

See the answer to question 39.

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

We are doubtful as to the benefit of increased audited disclosures by firms to clients, because such disclosures are only really effective if the recipient is able to check the figures, and in many cases - for example, discretionary management - this will not be possible.

What we do think is worth considering, however, is a requirement for an outside review of how an investment firm treats its client money. One of the lessons of *Lehman v CRC* was that the bank had misunderstood the client asset rules, so that money which ought to have been categorised as client money, was not. We see merit in requiring each investment firm to obtain both a legal and an auditing opinion as to how money and assets should be treated, as wwell as the auditors confirming that the treatment has been correctly applied.

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

Although there is logic in making a single individual responsible for oversight of client assets, we think it needs to be clarified as to what the consequence would be for that individual of failing in his or her duties. If the relevant individual is exposed to claims on a personal basis from clients who have lost money, this will deter people from accepting such a position.

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?*

The costs of each investment firm establishing a bankruptcy remote vehicle would outweigh the benefits. The suggestion of a bankruptcy-remote vehicle would only be feasible if there were a limited number of such vehicles - perhaps no more than three or four. This in turn would create an oligopoly with a consequent increase in fees and an inability to negotiate the provisions of the contract (such as we currently see with custodians). On balance we believe that the answer lies in better application and policing of the rules, rather than creating new rules.

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?*

A distinction needs to be drawn between money being transferred overseas for investment purposes (which is perfectly acceptable, even if it may be risky) and money which is transferred overseas simply because it fits in with a particular group structure. It is this latter case which presents a concern. We agree that in such a case there should be restrictions on transfer if, as a result of the transfer, the clients are not protected.

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

We think it is reasonable for depositaries and custodians to retain a lien for their fees in respect of the assets which they hold. What is not reasonable is for custodians to collect fees out of a particular client's assets where those assets have not given rise to the fees being collected. This could happen if the assets are in an omnibus account or if the assets are pooled before deposit with the custodian.

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

No. We think this is a bad idea. The protection of client money should not depend upon what that money is being used for.

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?*

In principle, it is sensible that there is a date after which an administrator or liquidator can distribute client money without being at personal risk of a claim. The answer to this question depends, however, upon the answers to a number of other questions. For instance, although it is suggested in the consultation that any shortfall should be borne proportionately by all clients, there is an argument for saying that if someone can establish that the full amount of their money was held in the client account, then they should be paid that full amount of money. Similarly, it must be recognised that many clients may know that they ought to have money in the client account, but will not know what the amount of that money is, and so will not be able to make a specific claim.

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 'futureproof' and do they have a limited negative impact?*

The Government rightly recognises that client money is held in a commercial context, and the rules governing client money must not be so restrictive as to impose quickly increased costs and administrative burdens. We doubt very much whether any proposals will be "futureproof".

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?*

As mentioned a number of times, our view is that the failings illustrated by Lehman are failings more of the application of the rules than of the rules themselves, and that this is the area where the Government should be looking at making changes.

Eversheds LLP
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Investment Banking Resolution
HM Treasury
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March 15, 2010

Dear Sir / Madam,

Establishing Resolution arrangements for Investment Banks

Fidelity International ("FIL") welcomes the opportunity to comment on the proposed HM Treasury consultation paper ("HMT Paper") and broadly agrees with the tenor of the IMA response and its specific answers to the questions raised. FIL is an asset manager serving investors in all corners of the world outside North America. It was established in 1969 and manages all significant asset classes for institutional and retail investors in long-term savings products. FIL and its subsidiaries employ over 4,400 people in 21 countries managing US$211.8 billion worldwide (as at 31/12/09). Fidelity's UK organisation comprises seven separately regulated firms, through which it conducts it's UK based investment management, distribution and administration activities. In addition and as noted below, asset managers in the UK comprise a large part of the equity market.

FIL has reviewed the HMT Paper on the basis that asset managers are not included within its remit. We understand that the main thrust of these proposals is to seek to address the obvious failings apparent when LBIE was put into administration. The asset manager's business model is fundamentally different from an investment bank and is very simple, it poses neither a risk to the financial system or to investors whose assets are held by a custodian, the "too big to fail" concern does not apply to the standard asset manager. Asset managers in the UK comprise 43% of the equity market and FIL would therefore like to offer its views to HMT on the proposals and to point out that like other industry players FIL was seriously affected by the Lehman failure.

FIL would like to see more specificity in such papers and the other proposals emanating from both Government and other interested bodies. The HMT Paper refers to "investment banks" in its title but throughout the document other terms are used to describe the entities it purports to cover. The definitions arguably capture not just the traditional UK asset manager as an "investment firm", but also many brokers and IFAs, which is clearly not the intention and could adversely impact a number of companies, including the UK asset management industry and would hinder that industry's ability to compete with European or other global asset managers.

In separate and public discussions we have been advised by and understand that HMT's intention was that none of the proposals would apply to asset managers, except where imposed because of banking activities elsewhere in a particular group structure.

There are a number of points however in the HMT paper (Section 6) where FIL would advocate taking a bolder approach to that advocated by the IMA and one which should not be more onerous either from a regulatory or cost perspective. Those points are set out below in paragraphs 1 through 6 and reference the numbered questions in the HMT Paper. We also offer some other observations on the HMT Paper for your consideration. We would, however, point out that we fully support the IMA initiative and unless specifically referred to below, we concur fully with their specific suggestions.

<u>Alternative Suggestions</u>: When Lehman failed the credit markets froze and client equity transactions were locked in a suspended condition. What is essential to maintaining an orderly market is certainty; therefore changes made, as a result of the post-Lehman analysis, should provide this. FIL's view is that the following would assist in providing certainty.

1. (Question 63) TSO flagging may not work, because of the fragmentation of the market and the way brokers handle large orders. Where brokers break up orders they will often state that most, if not all, trades were OTC. However, all (including OTC) trades are reported to the FSA as part of the transaction reporting process, introduced by MiFID and this has been broadly adopted. It would seem preferable for the FSA to put in place a system, which would enable it to quickly evaluate the data and highlight the trading venue in each case based on a review of the transaction reports submitted to it. This may require some modification of the reporting process but would be more efficient and an easier 'fix'. The reporting parties should be required to clearly state the venue, and all venues where multiple venues are used, on all such reports. We believe regulatory guidance is needed here.

2. Settlement on a T+3 basis is the current norm in the UK. Germany has T+2 as does a number of other countries with which we actively trade, including Hong Kong. FIL favours a move to T+2.

3. (Question 65) The LSE, with input from other venues such as CCPs and MTFs, should agree standard default terms which would apply in every circumstance and have an FSA imprimatur. Any party following the default rules would get Part 7 protection, and buy side clients of an insolvent firm should also be able to rely on such default rules. Giving blanket immunity to all MTFs might lead to them behaving irresponsibly.

4. The CREST system disappointed participants in the Lehman debacle. At FIL we could get no information from it about our trades and / or whether they would settle. This should not happen again, but the new CREST proposal is not ideal.

   FIL's view is that the optimum position for market participants is that all trades in the system (i.e. trades executed by broker and confirmed manually or electronically) at the time of insolvency, should settle. Therefore its proposal is that CREST should be mandated to settle all transactions in the system ("Existing trades") at the moment of insolvency but not to accept new trades. As the brokers post margin and there is a default fund (one or both of which may need to be increased) settling Existing Trades should not be problematic and CREST's position would be protected. Also market participants would avoid uncertainty and get the benefit of their intended bargains.

The suggestion in the HMT Paper, that CREST would disable participants and remove pending instruction from the settlement system to a 'shadow' account with a possible re-instatement of the trade 60 days later, appears to us to be sub-optimal, cumbersome and would offer less certainty.

We would also suggest, though have not ourselves explored, that CREST could seek insurance cover for any potential risk, not covered by the margin and / or the default fund.

5. Terms of Business (Box 6A, Question 78 and 79). FIL is supportive of an initiative to prepare terms of business (TOB) for all trades. While the AFME protocol may be a good starting point, this initiative must have input from asset management and others, it is unacceptable in its current form. FIL has been involved in discussions with its brokers on Fidelity wide TOBs and separately with IMA and LIBA on devising a standard form of TOB, these discussions have not yet been successful. AFME appears not to understand the fund management structure or to accept that the fund manager is an agent for the fund's shareholders. Considering that such a legal structure has been in place for many years, AFME's position is puzzling and the buy side firms are wasting time on such negotiations. All parties recognise that the 'battle of the forms' is a legal nonsense.

FIL's view is that standard TOBs are essential and the effort to agree suitable TOBs requires FSA backing and approval. FIL would therefore suggest that chosen industry representatives (buy and sell side) and an FSA appointed expert are charged with agreeing terms within the next four months. Once agreed and blessed by FSA, all parties would be bound by the TOBs which would cover both OTC and on-exchange trades. If parties felt that they wanted separate TOBs, they would be free to negotiate such terms which would have to be signed by both parties, acknowledged by such parties' affiliates and parent and specifically exclude the standard TOB.

This is an important matter that should be dealt with as part of the current consultation and not in a subsequent paper, as appears to be contemplated in the HMT Paper.

6. In the case of international brokers with headquarters, parents or major subsidiaries outside of the UK, clear rules should exist to ensure that moneys are retained in the UK which are sufficient to enable the broker to

meet its obligations for a defined period (e.g. 7-12 business days) and this should be closely monitored by the FRC (or FSA).

Other Observations on HMT Paper:

Paragraph 6.42: FIL does not see how these suggestions would work other than in the case of an "agency only" broker.

Paragraph 6.50 – 6.54: Considering the stasis that occurred post-Lehman, FIL is unsure how portability would occur. Since MiFID, there may be more competition but it has been at the expense of certainty and transparency. There is now no central clearing house and LSE, in the Lehman situation, was unable to advise on the status of trades. How could margin be assessed in such cases or transferred to a third party.

Question 66: A single central clearer may be worth considering but in its absence, clear rules applicable to all should be put in place, so that if different clearers are used by a broker each one would apply the same rules to the fragmented order.

Question 68: As asset managers trade as agent on behalf of separate and independent funds, set-off between such funds is not possible.

If you would like to meet with us to discuss any of the foregoing we would be very happy to meet with you.

Yours faithfully,

Mark Northwood
Global Head of Trading and European Capital Markets

cc Guy Sears, IMA

MARCH 2010

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 144 – INVESTMENT BANKING INSOLVENCY PANEL PROPOSALS

Response to the December 2009 HM Treasury Consultation Document on establishing effective resolution arrangements for investment banks

c/o Bank of England

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1. Introduction and Executive Summary

A) Introduction

1.1 In May 2009, HM Treasury published a consultation document entitled "Developing effective resolution arrangements for investment banks" (the "First Consultation Document"). This was the first consultation document in a series of three to be published by HM Treasury on establishing an effective resolution regime for failing investment firms. The First Consultation Document discussed certain issues that were highlighted by the collapse of Lehman Brothers International (Europe) Limited ("LBIE"), including the treatment of monies and assets belonging to the bank's clients and the treatment of open or unreconciled over-the-counter trading positions following the bank's collapse. It examined what could be done to make the process of insolvency itself more effective and to limit the damage that could be caused by a failing investment firm, outlining, in each case, the UK Government's (hereafter, the "Government's" or "HM Government's") initial thinking on these matters. The Financial Markets Law Committee (the "FMLC") responded, in July 2009, to the First Consultation Document in its paper, "Issue 144 – Investment Banking Insolvency Panel Proposals: Response to the May 2009 HM Treasury Consultation Document on developing effective resolution arrangements for investment banks" (the "Original 144 Paper").

1.2 HM Treasury published, in December 2009, its second consultation document, "Establishing resolution arrangements for investment banks" (the "Second Consultation Document"). After undertaking an initial consultation with industry experts, the Second Consultation Document sets out in greater detail the Government's thinking on establishing an effective resolution regime for investment firms and contains more than 30 policy initiatives designed to mitigate the impact of a failing investment firm.

1.3 This paper focuses on a number of the proposals raised in the Second Consultation Document including, *inter alia*, those associated with the return of client assets and the termination of derivatives contracts and responds to questions set out in the Second Consultation Document (the "Questions") which are relevant to the proposals discussed herein (i.e. Questions 8, 16, 21, 35, 46, 55, 73 and 80).

1.4 Client assets, as referred to in this paper, are the financial instruments that belong to the clients of an investment firm and are held on their behalf by the investment firm in the course of its investment business. Similarly, client money is money that an investment firm holds for or on behalf of a client in the course of its investment business.

1.5 The role of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed. This paper, therefore, does not comment on the many important policy issues raised in the Second Consultation Document which are relevant to the establishment of an effective resolution regime for investment firms other than as necessary to deal with issues of potential uncertainty or misunderstanding.

B) Executive Summary

1.6 This paper does not seek to address all of the questions posed by the Second Consultation Document, nor does it seek to identify exhaustively all potential concerns with respect to those proposals discussed herein. The purpose of this paper is to respond to certain key Questions and, in doing so, to set out the views of the FMLC on some of HM Treasury's core proposals and to make recommendations and propose, where relevant, solutions for consideration.

1.7 Accordingly, the FMLC's principal recommendations are as follows:

(a) Greater consideration needs to be given to the interaction of the investment firm special administration regime (the "SAR") with the special resolution regime (the "SRR") established for deposit-taking institutions under the Banking Act (as defined below), the Bank Insolvency Procedure (the "BIP") and the Bank Administration Procedure (the "BAP").

(b) The role of the business resolution officer (the “BRO”) should be clearly delineated and restricted to supervising the preparation of and maintaining, once established, the investment firm’s resolution plans.

(c) The proposals for investment resolution actions should be mindful of and consistent with the Tripartite Authorities’ objective of maintaining the stable functioning of the payments systems.

(d) Any proposed legislation or regulation aimed at clarifying how shortfalls in client omnibus accounts[1] are allocated should have regard to the relevant provisions of the legal framework for modern intermediated securities holding systems which was established by the UNIDROIT Convention on Substantive Rules for Intermediated Securities (the “Geneva Securities Convention”).

(e) Client assets held by an investment firm with a third-party custodian should not be subject to a right of set-off, a lien or other form of security interest in respect of liabilities owed by an investment firm, in its capacity as principal, to the third-party custodian. Contractual comfort should be sought, where possible, to this effect and in circumstances where such comfort cannot be obtained, clients must be made aware that their assets are available to the custodian in respect of the investment firm’s indebtedness.

(f) The technical aspects of having a special administration regime with an appointed administrator and an independently appointed client assets trustee (a “CAT”) needs further consideration, particularly with regard to, *inter alia*, how conflict will be managed and how the additional costs will be covered.

(g) Any attempt to introduce an explicit requirement for central counterparties (“CCPs”) to offer facilities for members to segregate their business should have regard to the Part 7 Provisions (as defined

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[1] For the purposes of this paper, an omnibus account is an account in which all “like” securities held by the investment firm, on behalf of its clients, are pooled.

in paragraph 8 below), amended, where necessary, to bring certainty to the process of transaction allocation and to ensure that a clearing member's insolvency is dealt with in an efficient and orderly manner with minimal risk of challenge.

(h) Certainty as to the eventual timing of (i) the early termination of derivatives contracts and (ii) the realisation of the value of open transactions is essential to the successful and efficient wind-down of an insolvent investment firm and the preferred solution for achieving certainty is a market-led solution which would, in effect, amend the terms of the standardised ISDA Master Agreement.

2. INTERACTION OF HM TREASURY'S PROPOSALS WITH BANKING ACT PROVISIONS

2.1 Overview

2.1.1 The Second Consultation Document briefly considers how the special administration objectives (the "SAOs") interact with the provisions of Part 2 (*Bank Insolvency*) of the Banking Act 2009 (the "Banking Act").[2] It emphasises the need for coordination of the applicable insolvency regimes in circumstances where a bank undertakes investment banking activities whilst also retaining deposit-taking permissions (a "Mixed Bank").

2.2 Question 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 described in Box 2A?

2.2.1 *Application of the SAR to Mixed Banks*

2.2.1.1 HM Treasury's consideration of Mixed Banks in Box 2A of the Second Consultation Document is limited to the interaction of the BIP as set out in Part 2 of the Banking Act and the SAR. No consideration is given to the interaction of (i) the SRR established for deposit-taking institutions under the Banking Act or (ii) the BAP as set out in Part 3 of the Banking Act with the

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[2] See Box 2.A on page 28 of the Second Consultation Document.

SAR. Moreover, the interaction of the BIP and the SAR is described only at a very high level. Greater detail and draft legislative proposals are needed to comment meaningfully on the legal aspects of the proposals although some high level observations have been made below on the assumption that provisions will be added to the SAR to take on board the SRR and the BAP as well as the BIP.

2.2.1.2 Given the potential for complexity in the interaction of existing insolvency law as it applies to banks (including the two modified insolvency regimes under the Banking Act) and the SAR, the authorities should take steps to ensure that the draft regulations establishing the SAR are clear as to their application and their effect on the rights of stakeholders. This is likely to require a thorough review of the provisions in the Banking Act and also consideration of their inter-relationship with the proposals set out in the Second Consultation Document, including “living wills”.

2.2.1.3 In addition, to maintain confidence in the wholesale financial markets, it is important that the SAR, or at the very least, the SAOs clearly define the legal rights of an insolvent investment firm’s creditors or clients. It is thought that this would, in the context of the resolution of a Mixed Bank, require certain amendments to be made to the existing guidance provided by the authorities on the application of the SRR.

2.2.2 *Application of the SAR following application of the SRR*

2.2.2.1 It is understood that the SRR will apply to Mixed Banks. Accordingly, the stabilisation powers which include, in particular, the Tripartite Authorities’ power to transfer a bank’s property (in whole or in part) may be exercised with respect to a Mixed Bank. The property transfer may, pursuant to Section 34(7) (*Effect*) of the Banking Act, include a transfer of client assets and client money; similarly, a property transfer under Section 33(2) (*Property transfer instrument*) may include deposits.

2.2.2.2 The need for such stabilisation powers in the SAR and the objectives of the SAR could differ from those of the insolvency regimes under the Banking Act and consideration needs to be given to the interaction of the SRR and SAR in this respect. For example, following the use of the SRR in relation to a failing bank, the BAP is typically used to deal with the residual company following the transfer. Where a failing Mixed Bank is subject to a partial transfer under the SRR, it is for the authorities to decide whether to transfer client money and/or assets to a private sector purchaser or bridge bank. Where they choose not to do so, it is not clear in the Second Consultation Document whether the BAP will be modified to accommodate the SAR objectives in relation to Mixed Banks and clarity would be welcomed in this regard. It would, however, appear that:

(a) for those residual companies which have retained a business involving the holding and safeguarding of client assets or client money, the SAR would be most appropriate and the application of the BAP should be modified to accommodate the relevant SAO; and

(b) for those residual companies which have not retained a business regarding the holding and safeguarding of client assets or client money, the BAP would be the most appropriate tool, and it should be clarified that the SAR modifications should not apply.

2.2.3 *Conflicting Objectives*

2.2.3.1 The statement in Box 2A of the Second Consultation Document that the pursuit of the objective set out in Section 99(2) (*Objectives*) of the Banking Act would involve no payout of estate or client assets is, in our view, fallacious. In this regard, we draw your attention to the comments made by the City of London Law Society in paragraph 13 of their comments on Part 2 (*Bank Insolvency*) and Part 3 (*Bank Administration*) of the Banking Bill[3] where it provides that the transfer of deposits to a third-party institution will likely require the transfer of equivalent assets; such assets may or may not be provided by the Financial Services Compensation Scheme.

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[3] See http://www.citysolicitors.org.uk/FileServer.aspx?oID=488&lID=0

3. BUSINESS RESOLUTION OFFICERS

3.1 Overview

3.1.1 The legislative changes proposed by HM Treasury to address the difficulties associated with winding-down large and complex investment firms centre on the appointment of a BRO. The BRO would be a director of the investment firm to whom

> the boards' collective responsibility for resolution could be delegated and who would be responsible for coordinating and overseeing the implementation of the resolution process.[4]

The BRO would have an important role to play in the investment firm's resolution. It would be responsible for, *inter alia*, drawing up business resolution plans pre-insolvency and implementing those plans upon the investment firm's failure.

3.2 Question 16: Do you have views on the coverage or detail of the BRO's responsibilities as outlined here?

3.2.1 If a BRO is to be appointed to an investment firm, the FMLC recommends that the role of the BRO should be clearly defined. Moreover, the FMLC is largely convinced by the arguments put forward by those who believe that the role of the BRO should be limited to overseeing the preparation and ongoing maintenance of the firm's resolution plan. Preparing for an investment firm's failure and instigating its ultimate resolution is likely to be a matter of systemic importance. With this in mind, careful consideration should be given to the interaction of the BRO with the board of directors in both an active trading context and a pre-insolvency context. Thus, specific responsibilities should be preserved for the collective expertise of the firm's board of directors. The board of directors should, for example, have a prominent role in the initial design of the resolution plan and it should be the board of directors collectively that decide when to implement the plan.

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[4] Paragraph 3.12 of the Second Consultation Document

4. RING-FENCING BUSINESS AREAS

4.1 Overview

4.1.1 The Second Consultation Document proposes that an investment firm should, in the two to three week period prior to becoming subject to insolvency proceedings (i.e. Phase I), carry out internal resolution actions with the objective of facilitating an orderly wind-down. One notable resolution action is the proposal that, during Phase I, firms should ring-fence safer parts of their business from exposures to more risky business areas (the "Ring-fencing Proposal").

4.2 Question 21: What are the obstacles to implementing investment firm resolution plans as suggested in this document?

4.2.1 Requiring failing investment firms to comply with the Ring-fencing Proposal is a matter of policy in respect of which the FMLC does not express a view. The Committee does, however, recommend that any obligation to comply with the Ring-fencing Proposal should be cognisant of the "Special resolution objectives" set out in Section 4 of the Banking Act and Chapter 3 of the Banking Act, Special resolution regime: Code of Practice (the "Code"). In particular, regard should be had to the objective of protecting and enhancing the stability of the financial systems of the United Kingdom (the "UK") which is concerned with protecting "the stable functioning of the systems and institutions (including trading, *payment* and infrastructure)"[5] (emphasis added) which support the efficient operation of financial services and markets.

4.2.2 It is important that the proposals for investment firm resolution plans, including the Ring-fencing Proposal, take account of the overriding need for the non-discretionary element of payment systems to remain intact. As long as a payment request is "valid" and the payment member has "sufficient liquidity", it will be processed by the payment system operators that are contracted to the UK's Payments Council (the "Payment Systems Operators").

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[5] Paragraph 3.4 of the Code

The manner in which payments are currently processed by Payment Systems Operators does not and cannot take account of the type of payment (i.e. whether or not it is in respect of a risky business area) being made.

4.2.3 Any attempt to protect a deposit-taking institution from the activities of a more risky affiliate should make full use of established structures which have as their object the protection of the overall integrity of the UK's payment systems. For example, in circumstances where an investment bank and a deposit-taking institution are a member of the same group and a member of a payment system, the Payment System Operators have discretion and, in certain circumstances, are required to suspend members when the integrity of their payment system is threatened. This method of suspension could be used by the authorities as part of any package of measures adopted to protect the assets of deposit-taking institutions.

5. ALLOCATING SHORTFALLS IN CLIENT OMNIBUS ACCOUNTS

5.1. Overview

5.1.1. It is common practice for client assets to be held by an investment firm in an omnibus account with a third party without differentiation as between one customer's holding and that of another. The omnibus account operates on the principle that each client's redelivery rights are fungible.

5.1.2. There is no settled principle of law which specifies how, on the insolvency of an investment firm, the shortfalls attributable to an omnibus account are allocated. Market practice often dictates that shortfalls should be borne *pro-rata* by clients in accordance with their percentage holding of the relevant securities and, generally, the contractual arrangements governing the relationship between the investment firm and the individual clients would expressly provide for such an approach. In the absence of such a provision, an affected client may, in light of an investment firm's failure, seek to rely on the complicated equitable "tracing" rule in an attempt to retake legal title to its *entire* percentage holding of the securities.

5.2. Question 35: Should the Government look to provide clarity over how shortfalls in client asset omnibus accounts are treated on insolvency?

5.2.1. The FMLC acknowledged, in its Original 144 Paper, that there was uncertainty in the wholesale financial markets as to how shortfalls would be apportioned in an omnibus client account following an investment firm's insolvency. Whilst the FMLC suggested that the uncertainty could be addressed by the market itself through the consistent use of clear contractual provisions, the Committee recognised that there may also be a need for regulatory or statutory clarification.

5.2.2. Since the publication of the Original 144 Paper, the Geneva Securities Convention has been adopted by diplomatic conference. The Geneva Securities Convention is an

> international instrument aimed at promoting internal soundness and cross-border system capability by providing the basic legal framework for the modern intermediated securities holding system.[6]

The protection of persons acquiring or otherwise holding intermediated securities is a key objective of the Geneva Securities Convention.

5.2.3. HM Treasury provides, in the Second Consultation Document, that the Government will continue to support the initiatives propounded in the Geneva Securities Convention and those set out in the much anticipated Securities Directive which is likely to be proposed by the European Commission later in 2010.[7] If clarification is to be provided on how shortfalls in client omnibus accounts are allocated, the FMLC recommends that regard is had to Article 26 (*Loss sharing in case of insolvency of the intermediary*) of the Geneva Securities Convention. Article 26 is supportive of the market practice referred to in paragraph 5.1.2 above and provides that, in the case of a group of account holders, any shortfall shall be borne by the account holders to whom

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[6] See "Background to the UNIDROIT Convention on Substantive Rules for Intermediated Securities" at http://www.unidroit.org/english/conventions/2009intermediatedsecurities/overview.htm.

[7] See paragraph 4.24 of the Second Consultation Document.

the relevant securities have been allocated, in proportion to the respective number or amount of securities of that description credited to their securities accounts.

6. CUSTODIAN'S RIGHT OF LIEN OVER CLIENT ASSETS

6.1 Overview

6.1.1 As highlighted above, client assets held by an investment firm are often pooled and are generally held in an account with a third-party custodian rather than in an account with the investment firm itself. In such instances, the investment firm often grants the custodian a right of set-off, a lien or some other form of security interest over the assets recorded in the account in respect of its indebtedness to the custodian. Clients are prevented from accessing their assets until such indebtedness is discharged.

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

6.2.1 The FMLC's Original 144 Paper raised the issue as to whether investment firms should require third-party custodians to waive any security interest, lien or right of set-off (to the extent permitted by law) over assets recorded in a client account with respect to liabilities owed by the investment firm in a principal capacity. In a similar vein, proposal 19 (*Change the regime regarding custodians' right of lien over client assets*) of the Second Consultation Document suggests that investment firms should seek comfort for their clients in the form of a "letter" from custodians stating that the custodian has no lien or right of set-off over client assets in respect of liabilities owed by the investment firm in its capacity as principal. Subject to paragraph 6.2.2 below, the FMLC is supportive of proposal 19 but recommends that it only applies to client assets held in an account with a *third-party* custodian where a lien or right of set-off is used as a means of reducing the custodian's credit exposure to the investment firm. The proposal should not apply to client assets held directly with the investment firm where the lien or right of set-off is granted to the investment firm in respect of the client's own indebtedness.

6.2.2 Contractual comfort as to the non-existence of a right of set-off, lien or other security interest over client assets could come in many forms (e.g. a provision in the standard terms and conditions governing the account or a provision in the agreement appointing the third-party custodian) and the FMLC recommends, therefore, that the contractual comfort required by proposal 19 is not restricted to that which is provided in "letter" format only.

6.2.3 The FMLC acknowledges that it will be difficult, if not impossible, to obtain contractual comfort from custodians based in particular jurisdictions (e.g. Russia) and that any rule or regulation encompassing proposal 19 would need to take account of such impasse. The Original 144 Paper suggested that those jurisdictions where contractual comfort was unattainable could be clearly identified to the client so that it is aware that its assets could be made available to the custodian in respect of the investment firm's liabilities. The Second Consultation Document is cognisant of the FMLC's suggestion in this regard.

7. ESTABLISHMENT OF A CLIENT ASSETS TRUSTEE

7.1 Overview

7.1.1 On the insolvency of an investment firm which holds client assets, the Second Consultation Document proposes that a CAT is appointed by the court alongside the administrator. The CAT and the administrator would be obliged to cooperate with each other. The CAT would be appointed to look after the interests of client money and asset holders and would be required to expedite the return of such assets post-insolvency. It is intended that unencumbered client assets would be released as quickly as possible while encumbered assets would be held until the administrator is satisfied that they are not required to satisfy the client's indebtedness to the general estate. Where the value of encumbered assets significantly exceeds the value of secured liabilities, the Government believes that, in order to maintain liquidity in the markets, the

CAT should prioritise the return of the excess money and assets (the “Excess”) to clients.

7.1.2 The establishment of a CAT is intended to address the difficulties faced by administrators of investment firms in protecting and promoting the interests of both the general creditor pool and those of clients who are owed money or assets by the investment firm as such interests may, at any given time, be conflicting. The conflict of interests is particularly acute where the client money or assets is secured in favour of the investment firm in respect of the client’s indebtedness to the investment firm.

7.2 Question 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?

7.2.1 In the Original 144 Paper, the FMLC had yet to form a view as to whether the prioritisation of the return of client assets would be best undertaken either (i) as an additional or overriding aim of the administrator, or (ii) by a newly created special insolvency officeholder such as the CAT which is outside the administration process. The FMLC examined, in the Original 144 Paper, the arguments for and against each of the two propositions.

7.2.2 The Committee has reconsidered HM Treasury’s proposal to establish a CAT and has determined that this is a policy initiative which is outside of its remit. For that reason, the FMLC does not purport to express a view as to whether or not it is appropriate to appoint a CAT to an insolvent investment firm which holds client money and/or assets. The FMLC considers it important, however, to highlight and, in part, reiterate some key legal uncertainties arising out of this proposal which have yet to be adequately addressed in the Second Consultation Document.

(a) <u>Mutual Cooperation</u>

The Second Consultation Document acknowledges that there will be difficulties in having a CAT appointed to an insolvent investment firm in addition to an administrator. The identification of encumbered assets is used as an example where differences of opinion may arise, particularly, when both the administrator and the CAT assert a claim over the same assets for their respective creditor pools. On that basis, it is proposed that both practitioners are subjected to a mutual duty to cooperate with each other although, in a somewhat contradictory fashion, their ability to challenge, through the court, the decisions of the other is preserved. HM Treasury is aware that care will need to be taken to ensure that any legislative developments in this regard address the potential conflicts that are likely to arise and in doing so, the FMLC recommends that each of the issues below are given due consideration.

(i) Hierarchical Structure

Rather than having an administrator and a CAT working independently in a parallel manner, the FMLC suggests that a mini-hierarchical structure should be considered as an alternative. This could be achieved through legislation (or regulation) which dictates the duties of the administrator and the CAT and the order of priority in which those ought to be carried out. The roles of the CAT and the administrator are not conclusively defined in the Second Consultation Document and further consideration needs to be given to those duties which are of interest to creditors and clients of the investment firm and, therefore, could be undertaken by either practitioner (e.g. who identifies the encumbered client money and assets).

(ii) *Administrator and CAT – appointment from the same firm or different firms?*

The Committee recommends that the administrator and the CAT should be appointed by the same firm as established communication lines would already be in place which would facilitate an effective flow of information between the two practitioners. If appointed by the same firm, it is unlikely that one practitioner would challenge, in a contentious manner, the decisions of the other and it is more likely that directions would simply be sought, in a harmonious way, from the court. Such an approach would also encourage both practitioners to work closely together in ensuring an orderly and efficient wind-down of the insolvent investment firm to which they have been appointed which would have the knock-on effect of reducing the costs associated with the firm's resolution.

(iii) *Information Flow*

It is vital to the proper performance of the CAT's duties that it has access to all information which is relevant to (1) the investment firm's holding of client money and assets including details of any security interest or other encumbrance which the investment firm has been granted over such client money and/or assets; and (2) the liabilities which are owed by individual clients to the investment firm and those which have yet to crystallise (e.g. open derivative positions and contingent obligations). As highlighted above, information would flow more readily if the administrator and CAT were appointed by the same consultancy firm. In any case, the FMLC recommends that legislative structures are put in place to endorse and facilitate information sharing between both practitioners as it would be overly burdensome for clients to have to prove their claims twice.

(b) <u>Derivative Positions</u>

In order to be able to ascertain the extent to which the value of secured client money and assets exceeds the value of secured liabilities, it is imperative that the CAT is able to determine the value of secured liabilities to begin with. This process is frustrated by the regime which operates in relation to the termination of derivatives positions. It is usually the non-defaulting party to a derivatives contract which has the right but not the obligation to terminate all derivative transactions. In addition, it is the non-defaulting party that would usually be empowered to value the net position outstanding post-termination (the "Close-out Amount"). There is no specified time period within which the non-defaulting party is obliged to terminate the transactions and whilst the transactions remain "live" the CAT will be unable to return any portion of the encumbered assets because the Close-out Amount attributable to such transactions can fluctuate daily, at times in a fairly volatile manner, up until valuation which should occur as soon as reasonably practicable post-termination. Possible solutions to this anomaly are considered in paragraph 9 (*Termination of Derivatives Contracts*) below. Once all "live" derivative contracts have been terminated, a structure also needs to be put in place to ensure that details of the Close-out Amounts are transmitted to the CAT once they have been agreed with the administrator.

(c) <u>Liability/Costs of CAT</u>

It is envisaged in the Second Consultation Document that the CAT would be able to make net distributions (i.e. a distribution determined on the basis of both a client's debts to the insolvent firm and the amount of money/assets held by the investment firm for that client) without personal liability. For this to be achieved, it is proposed that the CAT should be indemnified from the trust property in circumstances where it has acted in good faith but has still been held liable for loss.[8] Whilst the emphasis is very much on the swift return of client assets, establishing liability for loss is often a time-consuming process. With this in mind, it is difficult to see how the CAT could be indemnified from the trust property at a time after which such trust property has already been distributed. The same issue arises to the extent that costs associated with the appointment of the CAT are to be funded from trust property held by the investment firm as such costs will only be fully known when the CAT has completed the tasks for which it has been appointed (i.e. after client money and assets have been returned). Further consideration needs to be given to the practicalities of remunerating and indemnifying the CAT and whether it is envisaged that the CAT will have an unsecured cash claim against each client through which it must, effectively, seek to claw-back amounts which it has previously distributed. If this is the case, the CAT will be exposed to all the difficulties associated with such a process (e.g. enforcement problems, bad debts and time delays in receiving payment).

7.2.3 Regardless of whether or not the powers in Part 7 of the Banking Act are used to create a CAT, the FMLC considers the proposed SAOs to be an important advancement in the insolvency regime of investment firms which can, if necessary, operate independently of a new CAT regime.

8. SEGREGATION OF INVESTMENT FIRM AND CLIENT ACCOUNTS AT CLEARING

8.1 Overview

8.1.1 Client positions held by CCPs are often co-mingled with “the assets of other clients and the investment firm’s own positions in a house account”.[9] Co-mingling assets in this way exacerbates the problems associated with identifying an individual client’s holding and concern was expressed to this effect following LBIE’s collapse in 2008. Unsegregated accounts, on the

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[8] Paragraph 5.27 of the Second Consultation Document

[9] Paragraph 6.56 of the Second Consultation Document

other hand, reduce clearing member's margining obligations to the CCP as positions may be netted together with the clearing member's proprietary business. This, in turn, reduces the client's margining obligations to the clearing member.

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

8.2.1 Whether or not CCPs are required to offer facilities to members for the segregation of their business from that of investment firms is a matter of policy in respect of which the FMLC does not express a view. However, if such a requirement is imposed on CCPs, regard should be had to Part 7 of the Companies Act 1989 and the related regulations (together, the "Part 7 Provisions") which already require a CCP which is a recognised clearing house to provide for the separate netting and close-out of all client and house positions on the default of a clearing member.

8.2.2 The Part 7 Provisions are, however, deficient in some respects. If policy in this area is being reviewed and reliance is to be placed on a modified version of the Part 7 Provisions, the FMLC recommends that these deficiencies are first remedied. "Client positions", for example, are defined in the Part 7 Provisions by reference to the Financial Services Authority's client money rules. This is unsatisfactory because it denies the protection of segregation to transactions which have been:

(a) entered into by overseas entities which are not subject to the UK's client assets regime (e.g. EEA institutions operating through 'passported' branches in the UK); or

(b) segregated by agreement between the investment firm and the client.

It would be preferable to adopt a more inclusive definition of "client positions" which would encompass all positions which are held for clients and those in respect of which the clearing member has agreed or is required by law to segregate.

8.2.3 Whatever the definition of “client positions”, it is clearly important that the CCP’s default rules enable the CCP to deal with a clearing member’s insolvency expeditiously with a minimum risk of challenge from interested parties. It is, however, unclear, in the Part 7 Provisions, who is responsible for ensuring that transactions are correctly allocated as between the client and house accounts. There is concern that the allocation of transactions by CCPs would be open to challenge if it could be shown that transactions which should have been treated as client positions have not been treated as such. This risk of challenge would be removed or, at least, mitigated if the CCP was permitted to:

(a) place the onus on the clearing member to allocate transactions to the “correct” account; and

(b) provide that such allocation would be conclusive for the purposes of the CCP’s default rules.

The CCP would, as a result, be in a broadly similar position to that of a bank holding money in a client account. In such instances, the bank is required to confirm that it will not exercise any rights of set-off, but it is not expected to verify that the money in the account is actually client money.

8.2.4 These shortcomings should be remedied in the Government’s forthcoming review of the Part 7 Provisions and they should also be considered as part of the development of any broader obligation on CCPs to offer facilities for segregation of client and house positions.

9. TERMINATION OF DERIVATIVES CONTRACTS

9.1 Overview

9.1.1 Section 2(a)(iii) of the 1992 ISDA Master Agreement (Multicurrency – Cross Border)[10] provides that

> Each obligation of each party under Section 2(a)(i) is subject to (1) *the condition precedent that no Event of Default or Potential Event of Default has occurred and is continuing*, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement. (emphasis added)

In the initial period of uncertainty that exists after a party has defaulted, it is important that the non-defaulting party is protected and is not required to make scheduled payments or deliveries as they fall due as this would have the adverse effect of increasing, at the worst possible time, its credit exposure to the defaulting party. Such protection is afforded by Section 2(a)(iii) of the ISDA Master Agreement (the "Agreement") although there are no precise delimitations as to its use. Whilst the non-defaulting party has no obligation to perform its payment or delivery obligations under the Agreement due to the failure of the condition precedent, the defaulting party will be obligated to continue making scheduled payments and deliveries as they fall due and will even be required to pay default interest in the event of non-payment on a scheduled payment date.

9.1.2 It is perhaps not surprising, given that Section 2(a)(iii) is drafted as a condition precedent (and not, for example, as a suspensive clause), that the Agreement does not specify a time after which, if the condition precedent remains unfulfilled, the condition precedent falls away (or is deemed fulfilled)

[10] Most transactions are still covered by the 1992 ISDA Master Agreement, but the market is increasingly moving towards the 2002 ISDA Master Agreement. See paragraph 7.6 of the Second Consultation Document.

and the non-defaulting party is then obliged to perform.[11] It is also the case that Section 6(a) of the Agreement[12] confers a right, but *not* an obligation, on the non-defaulting party, by designating an Early Termination Date (as defined in the Agreement), to terminate all transactions under the Agreement following the occurrence of an event of default with respect to its counterparty. These two facts taken together mean that the counterparty may never be required to perform any further obligations under the Agreement, unless an Early Termination Date is subsequently designated in relation to it as a defaulting party, for example, due to its own insolvency.

9.1.3 In practice, therefore, Section 2(a)(iii) would appear to prevent a liquidator or administrator from recovering the positive net mark to market value it would otherwise be entitled to recover from a non-defaulting party if an Early Termination Date was designated under Section 6(a) of the Agreement.[13]

9.1.4 Investment firms will, at any given time, often have a multitude of derivative trades documented under their Agreements, both simple ("vanilla") and complex. The Second Consultation Paper acknowledges that this is the case and focuses on the uncertainty which Section 2(a)(iii) causes for the administrators and unsecured creditors of failing investment firms.

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[11] In the recent case of *Marine Trade SA v Pioneer Freight Futures Co Ltd* [2009] EWHC 2656 (Comm) [61], Flaux J interprets Section 2(a)(iii) as a "one time" provision, meaning that if the condition precedent is not satisfied on the due date of the relevant obligation of the non-defaulting party, then no obligation arises. This appears, however, to be at odds with the general understanding in the market that if the condition precedent of Section 2(a)(iii) is fulfilled at some point after the original due date (which may, depending on the nature of the defaulting party's default, be an actual or virtual impossibility), then the non-defaulting party is obligated to perform the relevant obligations. Flaux J expresses the view that, if that is the intention, then the document should state that explicitly. It is not clear, though, why that view is more compelling than the view that express words should not be necessary where the sensible economic result is clear, as evidenced by the predominant market view (which is generally supported by "textbook writers", as Flaux J acknowledges in his judgment). In other words, it seems equally, if not more compelling, that express words should only be required where the intent is for the provision to operate as a "one-time" provision, given that this is an odd result economically.

[12] Section 6(a) governs, by reference to the events of default in Section 5(a) of the Agreement, the circumstances in which a non-defaulting party may designate an Early Termination Date in respect of all transactions under the Agreement or in which, if the parties have so elected, an Early Termination Date may occur automatically. The latter case (automatic early termination) is relatively rarely elected, especially in relation to an English-incorporated party and so for convenience references in this paper are only to the designation of an Early Termination Date. Notwithstanding the above, the analysis of the current point is the same, whether an Early Termination Date is designated or occurs automatically.

[13] Obligations that would have been required to be performed by the non-defaulting party under Section 2(a)(i) of the Agreement but for the condition precedent in Section 2(a)(iii) are included in the final close-out calculation, as well as the mark-to-market value (effectively, the replacement cost) of all of the terminated transactions and, of course, amounts owed by the defaulting party that were due and unpaid as of the Early Termination Date.

Administrators of failing investment firms do not know whether the firm's non-defaulting counterparties will *ever* designate an Early Termination Date. On that basis, there is also uncertainty as to whether or not the value of open positions will ever be realised. Whilst such uncertainties exist, administrators also face difficulties in trying to establish and maintain effective hedge positions for the failing investment firms to which they are appointed.

9.2 Question 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?

9.2.1 The Second Consultation Document sets out, in paragraph 7.12, three possible solutions to the problems caused by Section 2(a)(iii), each of which has been considered by HM Government and is identified below:

(a) legislating for automatic termination of all transactions under the Agreement in the event that a party becomes subject to the appointment of an administrator;

(b) legislating for the termination of contracts by counterparties within a certain time period; or

(c) encouraging the market to develop a solution that preserves any perceived benefit of Section 2(a)(iii) while providing sufficient certainty to the administrators as to the eventual timing of early termination and therefore realisation of the value of open transactions (the "Market Solution").

9.2.2 HM Government highlights its preference, in paragraph 7.13 of the Second Consultation Document, for the Market Solution and suggests that any such solution should have the effect of promoting "a greater degree of certainty with respect to derivatives transactions terminations". The FMLC agrees with HM Government in this respect for the reasons set out below.

9.2.3 The International Swaps and Derivatives Association, Inc. ("ISDA") is often seen as the voice of the international derivatives market. The Agreement consistently features in the documentation of derivatives transactions and is, therefore, of fundamental importance to the derivatives industry as a whole. On the basis of the foregoing, it is imperative that the derivatives industry, as opposed to the legislature or the financial services regulator, resolves any uncertainties caused by key provisions of the Agreement which it pioneered through ISDA. It would, therefore, be logical for ISDA to pre-empt any legislative or regulatory intervention and to lead the market in proposing solutions to the issues highlighted in paragraph 9.1.4 above. The FMLC has briefly considered two alternative suggestions (below) as Market Solutions but defers to ISDA on the question as to which, if any, of these solutions is both feasible and desirable or whether some variant or alternative to these solutions would be the best approach.

9.2.4 First, it is notable that Section 2(a)(iii) is customarily modified in Australia by the inclusion of the following additional termination event (the "Proposed ATE") in the schedule to the Agreement:

> An Event of Default occurs with respect to a party ("Party X"), Party X has satisfied all its payment and delivery obligations under Section 2(a)(i) with respect to all Transactions and has no future payment or delivery obligations to the other party ("Party Y") whether absolute or contingent under Section 2(a)(i) (the "First Condition"), and Party Y refuses to make a payment to Party X based upon the condition precedent in Section 2(a)(iii) (the "Second Condition"). For the purposes of the foregoing Termination Event, the Affected Party shall be Party X.[14]

9.2.5 The Proposed ATE entitles the defaulting party, in the event of non-payment by the non-defaulting party, to terminate all transactions under the Agreement provided that the defaulting party has no future payment or delivery obligations thereunder. If a non-defaulting party does not want to continue trading with an insolvent investment firm, the non-defaulting party will, effectively, be required to terminate all transactions under the Agreement.

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[14] See *Enron Australia v TXU Electricity* [2003] NSWSC 1169 and *Enron Australia Finance Pty Ltd (in liquidation) v Yallourn Energy PTY Ltd* [2005] NSWSC 56, app [2005] NSWC 326.

With the Proposed ATE, a non-defaulting party will eventually be liable to account to the defaulting party for the positive net mark-to-market value of the terminated transactions under the Agreement.

9.2.6 The drafting of this additional termination event has yet to be perfected. The FMLC is aware that it has been the subject of intense scrutiny by the Australian courts where it became apparent that clarity was needed to ascertain whether the payment or non-payment of default interest could impact the satisfaction of the First and Second Conditions.[15] The FMLC suggests, however, that it offers a useful starting point for addressing the uncertainties highlighted by HM Government in paragraphs 7.5 to 7.14 of the Second Consultation Document. The FMLC suggests that a modified version of the Proposed ATE, adjusted to reflect the commercial agreement with regard to default interest, could be used to form the basis of a Market Solution.

9.2.7 Secondly, a Market Solution could be achieved through an amendment to Section 6(a) of the Agreement which would prescribe a time-period[16] within which a non-defaulting party, after the occurrence of an event of default with respect to its counterparty, must terminate all transactions under the Agreement.

9.2.8 Protocols are often used by ISDA to supplement or amend existing ISDA documentation and the FMLC considers that a "Section 2(a)(iii) Protocol" could be used to achieve either of the Market Solutions proposed above. An ISDA protocol allows each adherent to the protocol to amend its bilateral

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[15] In *Enron Australia Finance Pty Ltd (in liquidation) v Yallourn Energy PTY Ltd,* it was held by the Court of Appeal in New South Wales that Party X did not need to pay interest to Party Y to satisfy the First Condition and Party Y did not need to pay interest to defeat the Second Condition.

[16] *In re Lehman Brothers Holdings, Inc.*, Case No. 08-13555 et seq. (JMP) (jointly administered) one year was considered too long a delay in designating an Early Termination Date when facing a counterparty in U.S. bankruptcy proceedings. By delaying so long, the non-defaulting party was deemed by the US Bankruptcy Court to have waived its right to terminate. It is worth bearing in mind, however, that this part of the US Bankruptcy Court's judgment was concerned with how long the statutory safe harbour for early termination and netting under the US Bankruptcy Code is available to a creditor after the commencement of proceedings under the US Bankruptcy Code. It was not concerned specifically with Section 2(a)(iii) or its enforceability, although in a separate passage in the same judgment the judge indicates his view, with little supporting analysis, that the condition precedent in Section 2(a)(iii) is not enforceable under the US Bankruptcy Code. In other words, it would appear, although the judgment is somewhat cryptic in this regard, that even a short time limit would not rescue the enforceability of Section 2(a)(iii) under US insolvency law.

ISDA documentation with each other adherent to the protocol, eliminating the need for dozens, if not hundreds, of separate bilateral negotiations while also ensuring a relatively uniform result across the market.[17] Parties also, of course, remain free to agree bilaterally to amend their Agreements based on the standard language set out in any "Section 2(a)(iii) Protocol" (perhaps with certain adjustments to suit their specific circumstances).

9.2.9 Whilst adherence to an ISDA protocol is voluntary, parties may, in order to promote a Market Solution proposed by ISDA, be encouraged or incentivised by regulatory action to adhere to a "Section 2 (a)(iii) Protocol". In this way, the legislative option, which HM Treasury indicates is not the preferred approach, could be avoided. It would remain, however, a possibility if market participants were slow to adopt the Market Solution.

[17] Some ISDA Protocols allow some elections to be made by an adherent when adhering, so that, to the extent that there is variation in the elections made, the Protocol does not ensure a wholly uniform result across the market.

FINANCIAL MARKETS LAW COMMITTEE MEMBERS[18]

Lord Hoffmann (Chairman)

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[18] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only. Whilst the Bank of England, the Financial Services Authority and HM Treasury participate in the FMLC, the views expressed in this paper are not necessarily those of the three institutions.

Investment Management Association

16 March 2010

Alex White
Investment Banking Resolution
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Alex,

Establishing resolution arrangements for investment banks

The IMA represents the asset management industry operating in the UK. Our Members include independent fund managers and investment managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of £3 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies). The IMA's authoritative Asset Management Survey 2008 recorded that IMA member firms were managing 43% of the domestic equity market for clients and £1.1 trillion in fixed income instruments.

We welcome the opportunity to comment on the proposals made in the paper. As you know we participated in the HMT working groups on issues such as scope, and assume that the points raised there need not be repeated here. Please find our detailed comments attached. The detailed points set out in our response to Chapter 1 setting out the differences between asset management firms and investment banks apply to all the chapters of our response.

I look forward to hearing from you if there is any clarification that you would find useful on the points we have raised. We would be happy to meet to discuss the thinking behind the market disclosure requirements.

Yours sincerely

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<u>Establishing resolution arrangements for investment banks</u>

We provide below answers only to those questions from the consultation that fall within IMA's remit

Chapter 1 - Introduction

We refer, repeatedly, throughout our response to the proposals raised in your paper to the differences between asset management firms and banks/investment banks. These can be summarised here:

- Banks/investment banks hold client assets and money connected with their investment business in their own name. If they become insolvent then clients may lose their assets or find them worth less as a result. This is not the case for asset management firms, which, although they manage client assets, do not hold them. They would be held on trust for the client by a custodian or bank or under the control of a depositary entrusted with their safekeeping. If the asset management firm were to become insolvent there would be **no** related risk to client assets, as the title to their assets remains unaffected. (This is also covered in our answers to Chapter 4.)
- The main asset that an asset management firm has is the mandate to manage the assets owned by its clients, and held by custodians.
- As a result, if an asset management firm were to head towards insolvency, the client base would be protected, either by the entire asset management firm being bought out by a better capitalised asset management group, or by the mandate to manage the assets of the client base being bought by another asset management firm.
- In the event of an asset management firm becoming insolvent their clients would **not** want their investments to be sold and their money returned. Such a return would cause retail clients to lose their tax advantages where assets had been held in ISAs or pensions, and the unplanned incurring of Capital Gains Tax etc. For institutional investors, who may hold several billion pounds in a wide portfolio of equities, bonds, commodities, real estate and derivatives, the sale of all these assets would incur considerable costs, take them out of the market for some time, and the impact of such 'forced selling' on the market would be very disruptive. **The aim of dealing with any insolvent asset management firm is continuity of management for their clients.** The responsibility for managing the assets and money held by depositaries should merely be transferred from the insolvent, or near-insolvent, asset management firm to the new firm (e.g. New Star to Henderson; Lehman Asset Management, as a separately constituted subsidiary of LBIE, survived intact and is now an independent asset manager Neuberger Berman). This is a key distinction between asset management firms and banks/investment banks, where the aim with the latter is to wind them up and return assets to their clients.
- Asset management firms tend to be much smaller, simpler and straightforward operations than the major international banks/investment banks. Due to their size and the types of business they undertake they are, in themselves, unlikely to raise systemic risk issues (the provenance of the assets managed, which includes much in the way of pension and insurance assets, are of course of systemic significance in other respects).
- Asset management firms are already required to keep full records of any client assets for which they are responsible, reconciling them fully at least every 25 days (CASS 6 and 7). All client money would be held in a client money account at a

bank, held in trust for the clients. All client assets are held in one or more custodians, which, again, holds them on trust for the clients.

We have discussed separately with yourselves and your advisers, how scope could be defined legislatively to make clear that these proposals relate to investment banks, not asset managers. We remain of the view that the ILAS approach by FSA identifies well the different types of systemically important firms. We would imagine that only the full ILAS firms would be within the class you are considering here (whether even all of those would is another issue).

Chapter 2 - Enabling an orderly resolution

We have answered the questions in chapter 2 on the basis that the term investment firm relates to an investment bank trading proprietary and client business. We do not think that these provisions are competent to address a wider group of investment firms and in particular asset managers with separate custody arrangements. We have had separate discussions with you on the subject of scope and will continue to do so.

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

We agree with a set of objectives that are procedural in nature. However, we agree that the administrator to balance four objectives at the same time will not work. You propose at 2.16 to prioritise the return of client money or assets. We continue to be of the view that engagement with market infrastructure bodies may be a far more immediate priority in some cases in the sense of requiring decisions and responses within hours. We consider that the return of client money or assets would more commonly be measured in terms of days not hours. For this reason we continue to think that the setting up of a separate client assets trustee and its use in appropriate cases, minimises the number of conflicting objectives to which an administrator may be subject.

As we have said in previous responses and described in a briefing note to you in 2008, a key aspect of any legislative change would be to make clear that an administrator or client asset trustee has a statutory obligation to administer trust assets and client money. In our view it would be better to limit the administrator's priorities to objectives 2, 3 and 4; objective 1 then being carried out by a partner of the administrator or a CAT. Objective 4, to wind up the firm in the best interests of creditors as a whole, in a timely manner, would not be breached by reason of the administrator prioritising objectives 2 and 3 in the first two weeks (or such longer time as the court may allow).

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?

Paragraph 74 and 75 of schedule B1 of the Insolvency Act 1986 should be qualified to protect administrators. Firstly, creditors should not be permitted to claim that the administrator is not acting in their best interests if he is following objectives 2 or 3 in the first two weeks, or such longer time as the court may allow. Secondly it may be appropriate to give a wider defence such as is available to trustees, so that if the administrator acts honestly and fairly and ought reasonably to be excused, the court can relieve him of liability. An issue is whether this relief could be ought on an ex ante or pre-clearance basis; we think that may be too problematic.

Consideration must also be given to liability in section 184 of Part VII of the Companies Act 1989 where an administrator has a very narrow protection from liability, particularly when compare it to the clearinghouse or investment exchange he may be dealing with.

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?

We are unsure in practice how this would help the administrator. No examples are given in the consultation paper.

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?

No mention is made in the consultation paper of the current procedure to seek directions from the court and how this would relate. We presume this question depends upon the approach taken to question 3 and whether following the direction of the court would be an absolute protection in every situation.

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?

We have nothing further to add.

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 financial stability? What specific modifications could the Government consider applying?

Yes. There should be statutory recognition that a director will not be at risk of an action in relation to wrongful trading if the steps he is taking are to engage with the authorities to implement a resolution plan. It should be possible to ensure that the requirement to take every possible step to minimise loss to creditors would be seen as being satisfied for some short period if some formal engagement occurred with the relevant authorities. The question will be as to how that formal engagement should be characterised so as to prevent a director merely avoiding his responsibilities by giving a less than adequate disclosure to the authorities. On the other hand a genuine attempt by a director to ensure that in the last stages of the life of the company, a resolution plan is implemented appropriately or the authorities are given a genuine opportunity to implement a resolution plan, should be seen as an option which advisers to the director can recommend without feeling that it conflicts with section 214 of the Insolvency Act 1986 in relation to wrongful trading or other duties as a director.

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 described in Box 2A?

Yes subject to the points we raise in answer to question 2.

9. Is there a case for considering 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?

We are unattracted by any suggestions that there could be wider calls for public finance support for failing banks.

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.

We have no comment.

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.

There was a perception that the UK authorities did not put out sufficient information about what steps they were taking. The perception was that the US authorities appeared to be providing more information. However the exchanges, clearinghouses and even the administrators themselves did provide information on dedicated areas of their websites and this was extremely helpful.

12. The Government considers the costs to market participants of a resource centre providing best practice guidance to administrators, and plans for coordinated 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

Not answered.

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?

We can see the sense in ensuring that the statutory powers are wide enough to allow opt-in subject of course to European obligations. It is our understanding that a passported-in branch of a bank that opted in would still be subject to full oversight by its home regulator and that therefore in practice any opt-in would be effective only so far as consistent with the wishes of that home regulator.

14. Are there any other specific issues in relation to cross-border investment firms, not considered here or in Chapter 8, that need to be addressed?

The obvious point is that cross-border investment firms are more likely to be subject to insolvency regimes in other countries. This gives rise commonly to issues where a procedural insolvency law may differ from substantive contractual obligations in the host country. Presently this is most starkly seen in the flip cause litigations and the so far inconsistent decisions between the US and the English courts.

15. The Government welcomes views on the extent to which the package of measures proposed in Chapters 2 and 3 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?

No.

Chapter 3 – Requiring firms to manage for failure

We refer to our opening remarks on scope. Working through Chapter 3 it became clear that most of the proposed requirements did, at some point, include some indication that their scope was restricted to investment banks or deposit takers. We have attached a table at the end of this chapter setting out references to all these statements. If it is the intention of HMT to restrict the impact of the Resolution Regime set out in Chapter 3 to such firms it would be helpful if this could be clarified in your final output.

Business Resolution Officers

Q16: Do you have views on the coverage or detail of the BRO's responsibilities as outlined here? Are these consistent or compatible with existing templates for the corporate governance structure of firms?

Few of the headline responsibilities of the BRO seem outside what is already required of asset management firms, if applied proportionately (paragraph 1.24 "policy proposals to be applied proportionately and to avoid placing undue burdens on smaller firms"), other than the new Business Information Packs ("BIPs").

Paragraph 3.12 indicates that only investment banks would require BROs, due to the size and complexity of their activities. Paragraph 3.20 also states that in developing RRPs the 'FSA will focus on deposit-taking firms'. Dr Thomas Huertas, Banking Sector Director at the FSA, in his speech on 12 February 2010, and Lord Turner, Chairman of the FSA, in his speech on 2 March 2010, both stated that RRPs are appropriate and proportionate for banks and investment banks given their potential systemic impact. They are right not to suggest that these proposals could be appropriate for asset management firms.

Asset management firms are much simpler organisations than either investment banks or deposit-takers, and mainly much smaller. They are already required, under SYSC 4.1.1/6, to have appropriate controls in place to manage their business and appropriate BCP arrangements in place. This seems to be a much more proportionate approach to this issue for non-systemic firms. Below we consider each of the elements of the BRO's responsibilities, with details of what is already required of asset management firms.

<u>Investment firm resolution plan</u>

We note that Chart 3.A states that resolution plans would only be required for investment banking businesses. As such it is assumed that these would not be required of asset management firms.

<u>BIPs</u>

FSA already requires asset management firms to have information on their operations and structure in place (SYSC 4.1.1, 4.1.4(1)). At paragraph 3.32 you state that "in addition to systemically important investment firms, firms with client assets and monies may also fall within the scope of this proposal". Thus asset management firms would seem to be out of scope for the BIP requirements.

Business Continuity

As discussed above asset management firms are very unlikely to become insolvent in a way that would disadvantage clients, investors, counterparties or the market as a whole.

Operational Reserve

Asset management firms already have their minimum capital requirements assessed on the basis of FOR (Fixed Overheads Requirement) that equates to enough capital to keep the firm running for three months. The FSA is already looking at asset management firms and requiring them to demonstrate that they have sufficient capital reserve to enable a safe winding-up.

BC-S and BC-V expenses are, we understand, Bank Suppliers' expenses and Bank Vendors' expenses, which would, again, indicate that these requirements are meant to be specifically targeted at banks only.

Communication Plans for Resolution

Asset management firms are already required to ensure effective internal communication (ref: SYSC 4.1.4(3), 4.1.8(3)). Effective and appropriate external stakeholder communication during periods of crisis for a firm is required by SYSC 4.1.4(3), 4.1.8(3), and where they are listed, or part of a listed group, DTR 2 and the Takeover Code Provisions on 'Disclosure of information which is not generally available'. UCITS IV is also introducing equivalent communication requirements on UCITS management firms to provide information to their clients.

As such we would look for HMT to confirm that the BRO is intended to be a requirement only for large, complex investment banking businesses, or, at the least that the requirement should be proportionate and take note of the areas of equivalent existing rules and requirements, so as to avoid duplication of effort or burden.

Q17: Do you agree with the basic policy of establishing a role for business resolution officers 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?

We do not consider that the imposition of BROs on asset management firms would be proportionate or necessary. As set out in our answer to Q16, the duties of the BRO are either not applicable to, or already required in a proportionate manner of, asset management firms.

It is only where a firm is both very large and complex that the advantages, for the firm, the FSA and the liquidator, of having a senior manager identified as a central point of contact responsible for all these issues outweigh the costs.

The FSA has already taken a view on which firms it views as having systemic impact as part of its implementation of Individual Liquidity Adequacy Standards ("ILAS"). The full rules are applied only to banks and investment banks, while the FSA has only applied the very highest level principles to firms such as asset management firms.

Q18: 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?

As stated above, we do not consider that the appointment of a BRO is proportionate or necessary for asset management firms.

For large complex organisations, such as investment banks, it would seem sensible for a role or this responsibility to be assigned to the Board. The Board takes unitary responsibility for the running of the company. They should be free to assign specific responsibility for implementation to a sufficiently senior individual within the firm. The FSA may wish to ensure that this individual is a Controlled Function, or even a Significant Influence Function. The amount of this individual's time that this role would consume may impact their other responsibilities, but this should be left up to each company affected to resolve.

Given the focus of the FSA and government on this issue, we can understand why the FSA wishes to ensure that the BRO is an Approved Person.

Q19: 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 in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

We have no comment to make on this question.

Investment Firm Resolution Plans

Q20: Do you agree that investment firm resolution plans can consist of internal actions followed by market-facing actions as proposed above?

Paragraph 3.20 states that in developing RRPs the 'FSA will focus on deposit-taking firms'; Box 3.A states the resolution plans are designed to 'allow large and potentially systemic firms to fail'; and the Financial Services Bill states that the FSA can impose the RRP requirements on 'authorised persons of a specified description', which must include authorised persons in relation to whom any power under Part 1 of the Banking Act 2009 is exercisable. As such, and for the reasons given above the IMA does not consider that the FSA should be required, or expected, to impose any requirement on asset management firms to produce resolution plans.

It is only where a firm is both very large and complex that the advantages, for the firm, the FSA and the liquidator, of having a resolution plan outweigh the costs. As such we consider that the requirement to produce resolution plans should be extended to all firms which, being both large and complex, could have systemic impact should they fail, such as investment banks.

For such complex firms it does seem reasonable that they are required to keep clear records of client assets, counterparty positions and business operations on an on-going basis. We have noted comments that it was the lack of such elementary record-keeping that has complicated the delay in resolving the LBIE insolvency.

Just for the information of HMT, asset management firms would already meet the requirements of the resolution plan set out in **Box 3.B** as follows:

<u>Client Assets</u>
All asset management firms are required to keep full records of any client assets, reconciling them fully at least every 25 days (CASS 6 and 7). All client money would be held in a client money account at a bank, held in trust for the clients. All client assets are held in a separate Custodian, which, again, holds them on trust for the clients.

Neither client money nor client assets can be rehypothecated onto the balance sheet of the asset management firm. (This point is also considered in our response to Chapter 4).

<u>Counterparty Positions</u>
On passing an order to a broker at an investment bank asset management firms are already required to record (COBS 11.5):

- the name or other designation of the client;
- the name or other designation of any relevant person acting on behalf of the client;
- the instrument identifier;
- the nature of the order, e.g. buy or sell or other;
- the type of the order;
- any other details, conditions and particular instructions from the client that specify how the order must be carried out;
- the date and exact time of the decision to deal by the investment firm;
- the name or other designation of the client whose order has been transmitted;
- the name or other designation of the person to whom the order was transmitted;
- the terms of the order transmitted;
- the date and exact time of transmission
- the unit price, price notation, quantity
- the counterparty; and
- the venue identification

<u>Business Operations</u>
The FSA is already encouraging asset management firms to consider what actions they would take if they were to enter a winding-up type of situation. This is now considered by firms as part of their ICAAP process. As we have also stated already asset management firms will always either be bought out in total, or have their customer base with their portfolios transferred to another asset management firm, before they become insolvent.

We are, however concerned that, the mere fact of the FSA asking a firm to initiate its Phase I actions, could precipitate it into insolvency, if the market were to hear of this. While it could be argued that the requirement by the FSA for a firm to enter Phase One is sufficiently significant information that the firm is obliged to inform the market of this (under SYSC 4.1.4(3), 4.1.8(3) or DTR 2) it is possible that DTR 2.5.3 would disapply this requirement. The FSA would have to be very careful that it did not, through accidental or pre-emptive disclosure, precipitate the very event it sought to avoid.

Asset management firms would already meet the requirements of the resolution plan set out in **Box 3.C** as follows:

Reconcile and return client assets and monies
As set out above, whenever an asset management firm gets into severe difficulties and approaches insolvency its client base, with all their investments, would be bought out by another asset management firm.

Clients would **not** want their assets returned (in one sense they have never gone away). Indeed the forced liquidation of their investments could cause havoc in the market place (it should be noted that IMA member firms manage 43% of the UK stock market) and would compromise clients' tax situations (particularly in terms of their ISA holdings and Capital Gains Tax position).

It is very important, in the event of an asset management firm getting into difficulties, those client assets and monies are **not** returned. What should be sought is continuity of management, either by the original asset management firm once bought out and recapitalised, or by another asset management firm.

Begin novating, terminating or settling open positions with counterparties
An asset management firm has a fiduciary duty to manage the assets of its clients. It cannot choose to stop doing so as it approaches insolvency. Any deals which are open at the point that a firm became insolvent would be novated over to the new asset management firm, which took over the mandate to manage the assets of the client.

As the assets are not held by the asset management firm, there is no risk to them at the point of insolvency, so no need to avoid open positions at that point.

Stop taking on new risks or new business and reduce market exposures
As for the above point.

Start disposing of certain fixed assets if required, e.g. gold reserves

All client money and assets are held in trust by separately regulated banks and depositories. As explained above these should not be sold off, but retained for transfer to management by another asset management firm.

Complete sale of business units where negotiations have taken place already
This is unlikely to apply to asset management firms.

Communicate relevant information to the market, staff and service providers
Appropriate communication is already required of asset management firms under Principle 11, DTR 2.

Clients are regularly provided with reports on monies and assets managed on their behalf by asset management firms (under COBS 16.3).

Q21: What are the obstacles to implementing investment firm resolution plans as suggested in this paper? What policies could the Government consider to address these, if any?

We are not aware of any obstacles (though we assume cost and system builds will be such) to deposit takers and investment banks implementing resolution plans as suggested, other than the fact that these requirements would be home state requirements, and thus not apply to any branch of EEA firms that operate in the UK under a passport. This could lead to considerable discrepancies between firms competing in the same market. It is important that the resolution plan does not constrict a firm's senior management from taking any action that is necessary, nor should it distract senior management from focussing on saving their firm.

We are concerned that the FSA ensures that it has appropriate mechanisms itself for making such decisions. Any individual or committee empowered to make such decisions should be sufficiently senior, and sufficiently well informed about the firm effected, the market generally and the implications of any actions they take. The FSA should be required to put adequate controls around their responsibilities in this area, setting out who will take the decisions, how they will be taken, what factors they should take into account and whose interests are to be served in doing so.

Q22: 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-£1million 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 outlined here, do you agree with the suggested costs for the prime brokerage business?

We note that the CBA is focussing entirely on prime brokerage and investment banks. This again seems to indicate that HMT intends this regime to apply solely to such firms.

We are unable to comment on the costs of the proposed regime to prime brokers and investment banks.

Q23: What resources do you expect the entire investment banking business of the firm to spend on resolution plan implementation? Costs would include those related to: (a) designing and setting up resolution plans in collaboration with the FSA; (b) the ongoing audit and update of resolution plans and their inclusion in the firm's corporate governance activities; and (c) the additional resources required to implement resolution plans in a distress situation, if any.

Please see our answer to Question 22.

Business Information Packs

Q24: Do you agree that business information packs will be useful to administrators and will fulfil the Government's objectives for a managed wind-down of investment firms?

Once again (paragraph 3.32) the paper indicates that the scope of the Business Information Pack proposals is limited to 'systemically important firms, and potentially of those firms that hold client assets or monies'. It would be helpful if this restricted scope could be confirmed.

We agree that BIPs could be of great value to administrators of systemically important firms.

While BIPs will be useful to administrators they will not, in themselves, fulfil the Government's objectives for managed wind down of systemically important firms, and those firms that hold client assets or monies; they will, however, help.

As explained above, asset management firms do not generally hold client assets or money themselves. These are held on trust for the underlying clients by separate banks and depositaries. Having said this, many of the items that would be required by a BIP are already required of asset management firms by the FSA rules:

<u>Business Structure</u>
Principle 3, SYSC 4.1.1, SYSC 4.1.4(1) require firms to organise their affairs responsibly and effectively; have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility; and establish, implement and maintain an organisational structure which clearly and in a documented manner specifies reporting lines and allocates functions and responsibilities.

<u>Business Information & Risk Management</u>
SYSC 4.1.4(3): firms must establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the firm.

<u>Business Strategy and Decision Making</u>
The FSA will already have a record of which entities have which legal permissions in its <u>Register</u>. A copy of this would be freely available to administrators.

Personnel
HR departments should have all of this information readily to hand.

Key Operational Costs & Logistical Information
Firms should have all this information as part of their BCP work (SYSC 4.1.6-8).

Funding & Liquidity
Principle 4: A firm must maintain adequate financial resources.

Q25: 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.

As in the case of resolution plans, there may be ongoing benefits to the investment banking business from having in place continually updated BIPs, but these are not included here.

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

We note that, again, the CBA is focussing entirely on prime brokerages and investment banks. This again seems to indicate that HMT intends this regime to apply solely to such firms. It would be greatly appreciated if such a restricted scope could be confirmed.

We are unable to comment on the costs of the proposed regime to prime brokers and investment banks.

Q26: 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.

Please see our answer to Question 25.

Continuity of Service

Q27: The Government would welcome views on what incentives and disincentives are likely to be effective and whether there are any concerns with the ones suggested above.

As has been explained above, asset management firms are very unlikely to go into administration with their clients still relying on them. They will invariably have been sold to another, better capitalised, asset management group, or the client base will have been bought out by another asset management firm.

This will leave the rump of the asset management firm, which does go into administration, with no regulated activities to conduct, rendering the need for 'key staff' to be retained rather moot.

We also note that 'the Government is of the view that the need to retain key staff applies only to investment banking businesses' (paragraph 3.53). As such, it seems that this requirement should not apply to asset management firms.

Q28: 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?

As we understand that the requirement for key staff retention applies to investment banking businesses, not asset management firms, we have no comments to make on this question.

Q29: What do you consider would be an appropriate measure to ensure that the fees that suppliers charge post-insolvency are not inordinately high? Do you believe the Government can take specific action in this regard?

We have no view on how to avoid inordinately high post-insolvency fees from suppliers.

Q30: 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 renegotiating 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. The cost implications of associated policy measures such as an operational reserve for the payment of staff and essential services, the BIPs and BRO are examined in the relevant policy sections.

Do you agree with the cost estimates suggested above, for contractual provisions for key staff and suppliers? What are your views on the incremental costs of: (i) renegotiating 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?

As noted above, the key staff retention requirement seems only to apply to investment banks. It is not clear whether or not that is also intended to be the scope for the post insolvency supplier retention requirements. If so, then we have no comment on the costs.

Q31: What alternative policy tools 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?

We have no comment to make on this question.

Operational Funding

Q32: What are your views on legislative changes requiring administrators to use the operational reserve only for operational expenses?

This seems reasonable. To allow the operational reserve to be used for any other use under the administration would undermine the rationale of requiring the reserve.

As has been explained above, asset management firms are very unlikely to go into administration with their clients still relying on them. They will invariably have been sold to another, better capitalised, asset management group, or the client base will have been bought out by another asset management firm.

This will minimise the necessity for the firm to have operational reserves for 90 days post-insolvency. We also note that the CBA refers only to prime brokers and investment banks, indicating that asset management firms are not within the intended scope of this requirement. It would be greatly appreciated if such a restricted scope could be confirmed by the HMT.

However, given that asset management firms, subject to the CRD, are already required to hold, at a minimum, the equivalent of three months operating costs (FOR) this should not present a particular problem.

Should asset management firms be included within the scope of this requirement then we would seek HMT's assurance that the 90 day operational reserve would not be in addition to the CRD required three month FOR but be equivalent to this.

Q33: 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 the suggested cost estimates above? 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?

We note that the operational reserve requirement CBA refers only to prime brokers and investment banks. This would indicate that the requirement is not intended to apply to asset management firms.

Q34: Do you have any views about the operational reserve proposed in Chapter 3?

The only point we would like to make is that, if it is intended to apply to asset management firm, then this operational reserve should be 'realisable within the 90 days' rather than being more narrowly defined as 'liquid' (which in some definitions can be restricted to Government bonds only).

Summary of Proposals and Scope issues in Chapter 3

HMT Proposal	**Limited extent of Scope**
Business resolution officers	Paragraph 3.12 "The size and complexity of ***investment banking activity*** pose substantial difficulties for investment firm resolution. One way to mitigate these difficulties would be to have an individual at board level… who would be responsible for coordinating and overseeing the implementation of the resolution process."
Investment firm resolution plans	Chart 3.A "Supervised plans… for the wind-down of the ***investment banking business***." Paragraph 3.20 "In developing these [Recovery and Resolution Plan] requirements the FSA will focus on ***deposit-taking firms subject to the special resolution regime in the Banking Act 2009***." Box 3.A "The resolution element, in particular, will be important for ensuring that the Authorities can allow ***large, and potentially systemic, firms*** to fail" Q22 "costs for the entire ***investment banking business***, including ***prime brokerage***…" Q23 "What resources do you expect the entire ***investment banking business*** of the firm to spend on resolution plan implementation?"
Business information packs	Paragraph 3.32 "The Government believes that in addition to ***systemically important investment firms***, ***firms with client assets and monies*** may also fall within the scope of this proposal" Q25 "costs for the entire ***investment banking business***, including ***prime brokerage***, would be…" Q26 "What resources do you expect the entire ***investment banking business*** to spend on BIPs' implementation?
Continuity of service arrangements – staff and suppliers	Paragraph 3.53 "the Government is of the view that these provisions should be applied to 'key staff' that the firm identifies within its ***investment banking business***" Q30 "The Government recognises that crossborder groups with ***investment banking business*** may negotiate contracts with staff and service providers on a central, group-wide basis."
Operational reserve	Paragraph 3.77 "The Government is considering whether to introduce legislative changes, using its powers under section 234(6)(f) of the ***Banking Act 2009***" Q33 "operational reserve of $25-50m would be required for the investment firm's prime brokerage business… This is likely to amount to approximately $10-30m for key staff only of the entire ***investment banking business*** of a firm. What is your estimate of the value of the operational reserve for the entire ***investment banking business*** of the firm"

Chapter 4 - Reconciling and returning client property

The issues highlighted within this chapter and relating to the collapse of Lehman Brothers International Europe (LBIE) were not necessarily seen as comparable issues for the asset management arm of LBIE. It should be noted that the asset manager (Neuberger Berman) continues to manage the assets of its clients; and that these assets are held not by the asset manager but by the clients' custodians. Also to note is that clients of asset managers would probably not want their assets and client money returning to them if the manager became bankrupt, as these are often part of wider tax planning or a pension portfolio.

Within this chapter, the term 'client' is referred to as those whose money and assets are held by an investment firm, with assets being the financial instruments that belong to these clients. The term 'client money' is defined as the money a firm holds itself or deposits with another firm, in a qualifying money market fund or other financial intermediary for, or on behalf of, a client in the course of its investment business. Such monies are distinct from money and assets of the investment firm itself.

For asset managers, there are two distinct areas of assets: those invested in financial instruments (client assets) and any non-invested cash waiting to be paid to the manager or to the client (client money). Asset managers will not look to hold cash long-term on behalf of a client, but there will be scenarios whereby cash is waiting to be invested or to be paid out to a client who has sold their investment.

Before the collapse of LBIE, relatively few discretionary asset managers entered into agreements permitting rehypothecation. These agreements tend to be a feature of prime brokerage services and for the main run of discretionary asset management there was little call to use this aspect of prime brokerage. Since the collapse, it is still not widely used; therefore we have found it difficult to comment on proposed changes to its use within this paper.

Both client assets and client money remain the subject of regular audits within an asset management firm and any client assets or client money must be held separately from those of the firm. Assets are recorded on a register and these are always held by a third party. This makes the client assets easier to identify by auditors and they remain unencumbered in any way. Client money is held separately from a firm's money and is reconciled on a daily basis.

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?

The FSA Handbook on Clients Assets (CASS) provides both rules and guidance for relevant firms. There is a requirement in CASS 7.6.13R for managers to ensure that any shortfall is paid into a client bank account by the close of business on the day the reconciliation was performed. Providing these regular reconciliations are carried out, there should be no need to provide further clarity.

If a firm cannot adhere to the above rule, there is an accompanying rule in CASS 7.6.16R which clearly states that the FSA must be notified without delay if having

carried out the reconciliation the firm has not complied with, or is unable, in any material respect, to comply with CASS 7.6.13R – that is, to pay the money into the client bank account by the close of business on that day.
Recent court decisions have however made it clear that the absence of rules that deal with the consequences in the trust of non-compliance, unreconciled positions or post-default events is not optimal. We believe that Government should focus on bringing clarity to this problematic regulatory gap, relating as it does to the handling of client money by the regulated firm in default. We see less need to focus on shortfalls within a client omnibus account caused by external factors, such as fraud committed by another client with a claim on the account.

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?

As an industry that supports the concept of transparency, we agree that appropriate warnings should be given to clients if there are any plans for the firm to pledge their assets in order to secure credit.

However as customers of investment banks, our members do not understand why investment banks should not be required to at least offer designated named accounts.

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

For asset managers, there are a variety of rules covering the information that must be given to clients both pre and post-sale. These are covered more fully in COBS 4 and COBS 13.

However as customers of investment banks, our members consider there should be more clarity within the contractual agreements between themselves and their investment banks. You are aware of the work by IMA on terms of business and this is referred to again in much more detail within Chapter 6.

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.

We have no relevant cost information as clients of investment banks. However as the investment banks update their contractual paperwork on a very regular basis, we believe the requirement would cause little additional aggravation.

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?

As customers of investment banks, our members agree there should be an increase in the requirements for reporting – especially for systemic investment firms.

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?

We remain convinced that a firm should be aware of which assets and monies belong to themselves and which assets and monies belong to their underlying individual clients. We believe that existing COB rules do actually require this. However, firms in stress not uncommonly fall down on record keeping. In financial markets, failure to maintain comprehensive records can produce chaos over a very short period of time, given the volumes handled daily and speed of settlement (eg T+2, T+3). If records have not been kept properly, no amount of rule-making will fill that gap.

It is possible that a lack of record keeping led to some delays when the administrators reviewed the books of LBIE. Clients are entitled to know which assets they own and any firm holding such assets or money on behalf of their clients should be able to identify them relatively easily.

As for the type of records held by a firm, this will depend on what type of assets they are holding and the level of sophistication and complexity of their business. If a firm has well founded systems in the first place, this can only help improve the outcome in the event of default. If the firm is in any way struggling with inadequate old or legacy systems, this will also impact on the outcome in the event of default. In our view it follows that supervisors should take a much closer interest in the state of all the large investment banks' systems, rather than merely impose new rules about record keeping.

The reason for holding a trade date is to clearly prove when a trade was carried out. Therefore we are not convinced that adding a second date would add any further protection to clients' assets. Firms need adequate systems to ensure any unsettled trades are identifiable in a timely manner and there are sufficient controls in place to settle these trades appropriately. We are not sure the extra requirement for this date adds any value, providing the trade dates are clearly recorded. Moreover, it could add very substantial cost and diversion of resource as it is likely to require wholesale amendment of existing systems.

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

All asset management firms are required to keep full records of any client assets, reconciling them fully at least every 25 days (covered by CASS 6 and 7). All client money must be held in a client money account at a bank, held in trust for the clients. All client assets are held in an independent Custodian, which, again, holds them on trust for the clients.

Independent auditors will then record in the annual report and accounts.

As customers of investment banks, our members support further transparency with regards to client assets and money.

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

The FSA are currently consulting with the financial services industry in their paper CP10/3: Effective corporate governance; whereby they have proposed a review of controlled functions within firms and these include an increased scope for the role of CF29. Therefore we would suggest that any changes to this function are joined up with the FSA's review of effective governance.

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.

We are unable to comment on these figures.

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?

Asset managers use the services of a custodian to safe-keep the assets of their clients. This means that as the assets are held by someone other than the client or the asset manager, should the manager fail, the custodian will continue to protect the client's assets. However these are held in a trust account by the custodian, whose creditors cannot access these assets should the custodian fail or become insolvent.

The UK client money and client asset regimes have held up well for many years and through many defaults, until the recent LBIE administration. Clearly, the issues arising from LBIE in relation to the regulatory regime for client assets need to be dealt with as a matter of priority. We have commented on this elsewhere, but note here that the issues include: the ability to grant rights of set off over segregated accounts; the removal of the requirement for an investment bank to gain written agreement to holding client monies in a non-segregated account; and the relaxing of the rules about the extent to which client money can continue to be held within the counterparty investment bank. We make this point because it is essential that, if bankruptcy remote vehicles were to be introduced, these should not in any circumstances be seen as a substitute for the full rigour of UK regulation of client money and assets. We would therefore seek explicit assurances that investment banks (a concentrated group of service providers) would be required to offer the full range of client money and client asset options and not just those involving bankruptcy remote vehicles.

Having said that, we can see that the use of bankruptcy remote vehicles may offer some protection to smaller players in the market, for example hedge funds that operate with lone prime brokerage contracts. We are nonetheless concerned that the proposal from some investment banks may have the consequence of having one's cake and eating it. It is not clear how the assets will be dealt with and accounted for for capital purposes in an ongoing business if they are then not available on a default. Government should be slow to create a new-type of captured custodian vehicle that does not have to safekeep during normal business.

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?

The issue is whether money or assets are moved because it is in the firm's interests or is a way of dealing with a difficulty within the firm (such as a credit ceiling being reached) or whether it is necessary for fulfilling an obligation for a client (we do not use the client's interests as the other side of the test as all too often this can be misused by statements that any cost saving at an investment bank is in the client's interests). So if an asset needs to be held in Taiwan for a client then it does; the rules cannot preclude this, though disclosure, consents and risk assessments may be needed.

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

Asset managers are not permitted to enter into any arrangements for securities financing transactions in respect of any assets held on behalf of clients. This is outlined within CASS 6.4.1R and states that a client must give express prior consent. This includes those clients whose assets are held in an omnibus account.

It should be noted that this rule covers all MiFID and non-MiFID business from May 2009.

However as customers of investment banks, our members think there should be some form of equivalence for investment banks. The position on set-off and liens in also addressed in chapter 6 in relation to portability and segregation. We think this is a wider issue and could also be cover a consideration of set-offs within an investment bank; for example, in order to ensure client money can be returned quickly to all clients, set-off for indebtedness of one client in a pool may need to be prevented.

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

It is not clear how a proposal to separately pool client money according to riskier assets would work, but in principle this should be explored.

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 submit a claim by a bar date? Should the Government impose a legal duty on an administrator or trustee to impose a bar date?

You have our previous replies on this subject – it remains important to distinguish between limitation-type bars, where action to recover or disrupt distributions is prevented, and those which extinguish property rights of the claimants (particularly if there are associated guarantees, insurances or third party liabilities). Bar dates should be used only for procedural efficiency not to alter substantive property rights.

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 over liens. Additionally there could be other 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; and**
- **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.

We cannot comment on this.

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 'futureproof' and do they have a limited negative impact?

We would need to see more concrete proposals.

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?

Banks/investment banks hold client assets and money in their own name. If they go into insolvency clients may lose their assets as a result. This is not the case for asset management firms, which, although they manage client assets, do not hold them. They would be held on trust for the client by a separate bank or custodian. If the asset management firm were to go insolvent there would be no related risk to client assets.

In the event of an asset management firm going insolvent their clients would not want their investments to be sold and their money returned. This would cause retail clients to lose their tax advantages where assets had been held in ISA or pension wrappers, and the unplanned incurring of Capital Gains Tax etc.

Asset management firms tend to be much smaller, simpler and straightforward operations than the major international banks/investment banks. Due to their size and the types of business they undertake they are unlikely to be of systemic importance. Asset management firms are unlikely to go into administration with their clients still relying on them. They will invariably have been sold to another, better capitalised, asset management group, or the client base will have been bought out by another asset management firm.

If an asset management firm were to get into severe difficulties, its client base, with all their investments, would be bought out by another asset management firm. In this scenario clients would **not** want their assets returned. Indeed the liquidation and return of their investments could cause havoc in the market place (it should be noted that IMA member firms manage 43% of the UK stock market) and would compromise clients' tax situations.

We have raised with you and the FSA previously about the need to consider using directions requiring client assets to be transferred to a trustee as occurred under the Financial Services Act 1986.

Chapter 5 - Providing clear and effective support for clients

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?

As described in Chapter 4, clients of asset managers do not necessarily wish for their assets to be returned to them as these could form part of their pension portfolio or tax planning. The concerns from our members are not from which firm the CAT would be appointed, but the ability of that person to understand the asset management industry.

The assets of our member firms' clients are already held in trust with a third party and are very distinct from those of the firm.

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?

Due to the features of assets managed by our members, we would favour the second option, with the CAT working alongside the existing trustee/depositary of the firm. To move the assets to another party could prove detrimental to a client's assets; the newly appointed CAT would need to have exemptions from the appropriate FSA permissions to carry out such activities

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

We have no comment to make on this proposal; but there are long-standing approaches developed by the judiciary (such as in Berkeley Applegate) which should be the starting point for any policy review.

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?

Clients of our member firms may not necessarily want their assets returned, as described earlier. More widely it should be considered; we are concerned that to date little consideration appears to have been given to the long-established judicial responses to such issues and why it is thought they are not adequate. It is not clear (though we expect there may be a very good reason) why the administrators of LBIE or the FSA did not apply for a Berkeley Applegate type order to be made.

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.

We have no comment to make at this time.

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?

We have no comment to make at this time.

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?

We have no comment to make at this time, but will watch with interest how FSA proposes this will be financed.

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?

We have no comment to make at this time, but will watch with interest how FSA proposes to become involved with the new CAT.

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?

Until there is further information about the scope of CAA, we cannot comment at this time.

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?

We will watch how this work will develop. We already follow the CASS rules and therefore will support propositions to make areas of the financial services industry more transparent. At present the cost of failure fails on the beneficiaries of the trust, or creditors of the firm; this suggest the cost will be placed upon the industry more which may not be the best-directed incentive.

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

None at this time.

Chapter 6 - Reconciling counterparty positions

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 to address incorrect TSO flagging, 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.

TSO flagging is not a new issue; it has rumbled on in the market since at least the mid-1990s, when the first new entrant to the equity exchange space challenged the London Stock Exchange's effective monopoly status. And it has been addressed over the years in changes to Conduct of Business rules set by FSA, as well as in the rule books of the exchanges operating in the UK.

It is therefore surprising that the issue remains effectively unresolved – and that the client impact in a broker/dealer default hangs off so fragile a basis as the correct flag buried deep in the firm's IT systems being switched on. The true cost of this episode was the cost to clients of their inability to unwind or settle positions, which in many cases included the cost of carrying market risk attributable to this inability to unwind or settle positions; all owing to an inability within the market to allocate trades accurately.

With that in mind, there has to be a significant question mark over the ability of firms', and their supervisors, to resolve this issue satisfactorily on a trade by trade basis in the future.

An additional complication is that the half dozen or so major UK broker/dealers usually specify in their terms of business that they will have the right to transfer trades around the group, sometimes also to third parties outside the group. This will often result in the trade being transferred outside the UK; sometimes it will permit trades to be moved outside the group too. This contractual term can effectively override protections that the UK might seek to introduce for investors using UK markets (the brokers will for example rely upon the FSA's "introducing broker" exemption to pass the trade outside the UK, rather than explicitly agreeing the pass on with the client). Although many investors will push back on this form of wording, it is not absolutely certain that they will always succeed, or that new terms of business sent in arrive at the right desk to be reviewed, or even that the timing of receipt and response are timely enough to remove the problem.

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

Better supervision of this work may help, but are not a substitute for clarity in regulation.

One action could be to permit the client to make the election 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

(Companies Act 1989 Part 7) for all the client-facing trades. The cost of such an election, in terms of fees charged by exchanges or clearing houses, should be small. This reflects that the purpose would be to ensure a more orderly default, and not to substitute for normal clearing and settlement arrangements; arguably, there may not need to be any charge made for the service other than in the event of a default. Should MTFs in the future be able to provide similar default protection, this election facility for clients should of course extend to them too.

As regards the point we raise in Q.63 relating to the ability of brokers to transfer trades, we suggest that at the very least the onus be reversed within (FSA Conduct of Business) regulation, requiring the brokers to obtain explicit prior client consent for the transfer of trades in-house or outside the UK.

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 for all affected parties, including creditors? What other options should the Government consider?

The default protections provided in Part 7 protect trades in transit such that the market can continue in operation notwithstanding a counterparty default. Since all organised trading, clearing and settlement systems form part of the market, the protections should be extended to them equally: otherwise, the purpose of providing the protection is partially undermined. As it stands, the fragmentation of trading and clearing venues introduced by MiFID is not recognised in terms of overall market protections in the UK. Indeed, the Lehman default brought the UK cash equity markets almost to a halt as regards outstanding client trades, whose status could not be determined for many months. This was highly detrimental to clients individually, but also came close to disrupting the settlement mechanism for the market as a whole, with consequent reputational risk.

We believe that the market confidence objective in FSMA is clearly intended to cover the client side of the market, not just the brokers.

We see no obvious disadvantages to extending Part 7 to MTFs. The other options considered in the consultation paper – such as requiring MTFs to use CCPs – do not appear to us to rule out the extension of Part 7.

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?

No. The AFME Protocol is designed to work for principal to principal business, but it does not address the needs of investors who are agents for underlying clients, such as the discretionary investment managers whom we represent. The discretionary investment managers form a significant group in the cash equity market, and act within a common business model and under the same regulatory conditions. They have ownership, through their management on behalf of underlying clients, of approximately 43% of the UK equity market[1]. The client base includes authorised

[1] Asset Management in the UK 2008 (IMA)

investment funds such as UCITS, pension funds, insurers, sovereign wealth funds and others. The nature of their business model introduces complexity as regards the handling of property rights and security interests belonging (so to say) to underlying clients, and this is not dealt with in the Protocol.

Although IMA and its members were not involved in the work to produce the Protocol, we did obtain a draft copy in January 2009 and contacted AFME (then LIBA) to discuss the difficulties posed for those acting in an agency capacity. This was acknowledged in a further draft of the Protocol sent to us in February 2009 (paragraph 1.5: *"In due course, to address the concerns of the investment management industry, it is envisaged that a second version of the Protocol could be produced, in conjunction with associations representing the investment management industry, which would deal with the adherence of parties trading as agent.*). However since then we have had no further contact from AFME on this issue.

The Protocol can only operate effectively if the 'trade system of origin' (TSO) issue is resolved.

An obvious improvement would therefore be to seek to have the Protocol extended to work for agents as well as principals conducting an OTC market trade. Overall, however, it will always be the preference of the investors to have default arrangements embedded formally in legislation/regulation.

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?

As mentioned above, it will always be the strong preference of the investors to have default arrangements embedded formally in legislation/regulation. This gives more certainty of outcome; and removes the possibility of adverse changes introduced to suit the broker dealers, who are the commissioners, payers and users for the Protocol.

As things stand, the Protocol is of little use to a large and important group of clients in the market, namely the discretionary asset managers. Formal regulatory status for the Protocol may be taken to indicate that the default handling problems suffered during the LBIE administration have been dealt with across the market, when clearly this is not the case.

Therefore we would not support the Protocol being placed on a regulatory footing without first requiring a solution such that it would work for agents with underlying clients as well as pure principals to a trade. The longstanding inability of investment managers to agree adequate terms of business reflecting their agency status gives rise to concerns that, once a regulatory footing is achieved, there will be no incentive for the broker/dealers to try to find an agency solution for the Protocol.

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?

We have no comments to add.

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.

One possible asset class is Forward FX.

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?

The advantage of permitting client trades to be covered explicitly is that it would effectively ensure that the market remained operative notwithstanding a large default. It would replicate in legislation what has historically usually occurred in practice, but that broke down with the Lehman default.

However, this protection should be introduced in conjunction with other reforms. For example, one of the problems in the Lehman default has been the difficulty of transferring margin when the margin pools have been (possibly) subject to rights of set off granted outside the scope of the trades held at the clearing house and back-to-back. If a client's margin cannot be transferred, this puts contract portability at risk. And whilst the Part 7 arrangements are designed to operate outside the insolvency of the defaulting party, should there be uncertainties about property rights the clearing houses will be hampered in carrying out the client facing work.

We are not certain in this context what creditors it is proposed to cover. Since the public policy objective has been previously to extend protections to ensure that the market is not de-stabilised, we would argue that this objective must be intended to cover client impact as their contracts are an intrinsic part of the operation of the market; but not to cover creditors per se. The ability to move margin and contracts does not mean that a client will not be out of pocket, as clients are likely to be creditors too; it does mean that they will have certainty about their market positions and about how much margin is segregated and available to transfer to support these.

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

As mentioned above, it is important that margin portability is not looked at merely as a mechanism attached to the Part 7 protections, but is considered in relation to the other work on, for example, segregation, on client money and client asset rules, on whether minimum requirements should always be maintained for centrally cleared contracts.

The Government should be prepared to analyse the detailed impact of scenarios including gross as well as net margining. It is difficult for market participants to undertake this analysis as the only certainties that they have in terms of service availability and costing reflect existing arrangements, which favour net settlement across the brokers. The analysis should also take into account regulatory objectives as regards the base line protections in UK markets that UK regulators wish to see delivered. In this light, it should consider also the arguments for and against interoperability between clearing houses as this affects clients, rather than maintaining the focus on the broker/dealers.

72. Initial 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 also 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.

It is striking that, when Lehman defaulted, the central clearing mechanism attached to trades cleared through the London Stock Exchange order book brought absolutely no benefit to investors. Not only were their trades treated as principal to principal trades by Lehman, the poor quality reporting of all Lehman trades created confusion that lasted for many months over where the client trades had in fact been executed. Even had an investor explicitly sought to have access to segregation, this would have been denied them. We do not believe that this is a healthy position for the market, nor should it be maintained in the future.

The cost estimates seem rather blunt. Costs will vary in different market segments, reflecting the relative ease or otherwise of developing the current offerings. They will also vary from firm to firm, not always because of the firm's size but also reflecting decisions the firm has made in the past about what it wants to offer to clients. Segregated client money and asset accounts were a cornerstone of much of the UK regulatory protections in the decades after the 1986 FS Act came into effect. That the brokers have chosen to limit some of these facilities in the 2000s, following changes to the client money rules and in response to evolving market change, does not mean that they are unable to offer these facilities nor should it prevent their return. We point out that the annual maintenance cost would anyway be charged back in full to the client base, albeit not necessarily directly.

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?

Yes. History – Lehman – shows what happens when client protections are not explicitly required to be provided.

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?

Although choice does matter at the fringes, it is more important that the policymakers determine what the base-line level of client protection should be in UK markets. The question has been posed in terms of: "Do UK policymakers want London to be a safe trading environment or the Wild West?" It goes to the heart of reasonable investor expectations as to outcomes. It is not possible to offer Wild West choices and also make assumptions that this will result in a safe trading environment.

Therefore we believe choice should be offered only to the extent that reasonable investor expectations as to outcomes are first met. In practice, this will mean that choices are limited; that investment firms (broker/dealers) should not be allowed the option of offering only one type of service (choice, as this has over the 2000s acted to remove choice and to make the safest options impossible)

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.

We believe that the Financial Services Authority, as the markets regulator in the UK, should set out what it considers to the outcomes that reasonably every investor should expect to achieve within UK organised markets (for trades on exchange and centrally cleared contracts). The clearing arrangements should then be tested against this setting of the boundaries.

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

Yes, we believe it does. Further improvements should be achieved in other areas, such as coverage of Part 7 protections and client money/asset rule amendments, rather than by changing the mechanism proposed by EUI.

77. Have the key consequences of EUI's proposal to increase certainty of settlement been identified correctly and do the benefits for the market as a whole of the proposed revised approach outweigh these consequences?

We believe so.

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

Yes. The issue is whether too much has become negotiable in contract that should reasonably be addressed by market regulation, or established convention promoted by regulators. To put it another way, we believe that the reasonable expectations of investors as to outcomes are not fulfilled in UK markets and that this regulatory gap acts to their detriment. Some of the expected outcomes are dealt with elsewhere in the HM Treasury paper, but others are currently left to the vagaries of the broker-client negotiation over terms of business.

To support market confidence, one of the Financial Services Authority's statutory objectives in FSMA, we believe that there have to be certain immutable arrangements in how markets operate that regulators must act to maintain. For example, investors should not be forced into inquiry – and negotiation - as to their ability to segregate client assets, or to have these held outside the counterparty with which they deal; they should not be put in a position where their own regulatory obligations to clients are ignored in relation to their own status, requiring investment managers to obtain the necessary protections from brokers and dealers as a matter for negotiation, rather than right; nor should their agency status be routinely denied when it is a matter of fact rather than one of subsequent negotiation.

Currently, notwithstanding Lehman, an unsatisfactory position continues to prevail between investment managers and their broker counterparts, with much uncertainty about which terms apply in respect of any particular cash market trade. This arises when brokers issue terms to fund managers, who in turn rebut the terms in whole or in part, sometimes sending back terms of their own and asserting their primacy. The paper trail is rarely concluded satisfactorily, and even when agreement is reached this may be overturned by subsequent repapering. It is colloquially referred to as "the battle of the forms". The Lehman default merely illustrated what many people already knew, that there was a dislocation in the market between the trades executed between regulated firms and the legal expression of the business. This dislocation is in our view a market failure.

To help fill the gap, IMA developed "model" terms, which are published and available for use by anyone – although in practice they are designed to reflect the business model of discretionary investment managers who are also regulated firms. We believe that the IMA Model terms have correctly identified and resolved most of the issues arising from the agency status of discretionary investment managers. The benefits include:

- providing a benchmark to assist firms in identifying core issues affecting the relationship between clients and brokers;
- accurately reflecting the agency status of the discretionary investment manager with his clients;
- addressing the consequences which flow from the manager's agency status; and
- improving the transparency in relation to the broker's services in order to facilitate an informed decision on allocation of risk between the parties and to ensure a full understanding of the extent of services provided.

Since September 2009 IMA has, with its members, discussed with broker/dealer representatives the possibility of finding a market solution in this area. The IMA position is that currently there is one form of "model" wordings used in the market, those for principal to principal transactions (our analysis of a number of issued broker terms indicate that they cover the same ground using much common language, reflecting the reality that the small number of large London-based investment banks are advised by an equally narrow group of large London-based law firms). What the IMA has sought to promote is a second form of "model" wordings in addition, covering clients who operate as agents for underlying clients.

However our discussions have not been productive. Four lengthy meetings have been held, each attended by senior trading and legal personnel, as well as IMA and AFME staff. There has been no discussion of language, nor has there been a commitment by the broker/dealer representatives to look at or discuss any language in the future. The number of issues discussed has been few, some covering what IMA believes to be settled ground. For example, this includes discussions on the application of the money laundering regulations and on the "know your customer" rules. A considerable amount of time has been spent on disclosure of underlying clients – an issue which has already been dealt with in the IMA Model terms and in the Non-Investment Products (NIPS) code, although these were not discussed at the meetings.

Disappointingly the manner in which the IMA Model Terms sought to settle many of the issues between the managers and the brokers were never discussed, owing to a refusal by the sell side to include the Model Terms on the agenda of the meetings. This meant that there was no discussion on how protections for the broker had been built up (for example in the provision of warranties), nor how we had dealt with the long outstanding issue relating to the ownership of trades during the process of allocation.

A more productive discussion was held on the subject of the broker's Execution Policy, but this is not an issue that is central to terms of business, although of interest to clients in a general sense. (The terms of business need to address whether the client is receiving best execution; the execution policy is an expression of what the broker is doing but not a confirmation of the regulatory or contractual protections provided.)

Therefore we have concluded, with our members, that both the tone, content and time taken over the discussions indicate that they will not progress to a workable outcome and deliver recognition and appropriate treatment of agency status. A number of our members have reported that their brokers have refused to negotiate bi-lateral terms of business pending the outcome of the joint discussions. AFME and IMA agreed explicitly at the outset that the discussions should not hold up ordinary business, but it seems that they are in fact doing so. For this reason also we are reluctant to continue with the discussions.

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

We believe the balance has crept over many years to favour the broker/dealer community at the expense of investors. We believe that it is essential that Government and regulators should now step in to address this imbalance, leaving purely commercial issues to be negotiated in contract. We set out below some of the issues that are subject to dispute in the negotiation on terms of business, and that should be dealt with in regulation specifying minimum (but not low) standards of service provision in markets:

- Events of default and powers following such default are drafted only in favour of the broker and as a result the investment manager and his underlying clients risk legal uncertainty should the broker become insolvent.

- The capacity of the investment manager as agent is not recognised or not adequately addressed leaving the manager liable as principal and creating uncertainty because the consequences of the manager's agency status was not thoroughly thought through in the agreement.

- The manager is held jointly and/or severally liable with his underlying principal(s) even if its agency capacity is recognised.

- Investment managers should be classified as professional clients in respect of dealing activity, to ensure continuity of protections to their underlying client through the execution chain.

- Broker's rights over client investments (e.g. set-off provisions and powers following events of default) are not confirmed to the assets of a particular defaulting client (i.e. assets of other clients used in order to meet liabilities due from the defaulting client).

- The capacity in which the broker acts (at the time of trading or when the transaction is confirmed) is not sufficiently clear. The manager may, therefore, not always know what third parties the broker has involved in the dealing chain and on what legal basis. As a result, the ultimate risk of the transaction may not lie with the broker with whom the manager deals and in some cases the manager may not be aware of this.

- The lack of clarity over capacity and over the use of third parties by the broker impacts on the managers' obligations to transaction report. In the UK, asset managers are exempted from transaction reporting obligations where they have "reasonable grounds" to conclude that another party will report the transaction. The guidance for "reasonable grounds" is however undermined by the difficulty of establishing what the broker has done as the manager may not know when the obligation has reverted to him. (It should be noted also that the transaction reporting obligation is not applied to asset managers in other EU member states, other than Holland.)

- The broker does not take responsibility for the acts and/or omissions of their own group affiliates and/or third party agents (which might cause loss to the asset manager or its underlying clients) especially when such third parties are used in executing transactions.

- The manager is forced to give representations and warranties and/or covenants as principal (e.g. a representation and warranty as principal that, "any and all investments held by broker on Manager's behalf are beneficially owned by Manager" – this is not compatible with the agency capacity of the manager).

- Rights under the Contracts (Right of Third Parties) Act 1999 are not expressly granted to the manager's underlying clients.

- Issues relating to order handling and best execution are not adequately addressed. Brokers should be required to provide execution policies that provide insight and transparency into the choices they have made for executing client orders, including in a general sense about the outcomes delivered by the algorithms that run their DMA and other order selection systems. Brokers should also be required to explain how they have interpreted the requirement to disclose venues on which, when trading, they place significant reliance.

- Issues relating to conflicts of interest and how these are managed are not adequately addressed.

- The broker purports to bind the manager to intermediate third party broker terms without contemporaneous client permission.

We believe that regulation should be extended to deal with these mismatches in expectations and commitments.

Chapter 7 - Managing complex creditor positions

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?

If a suitable market solution is reached we agree that regulatory or legislative action is not required. The type of regulatory or legislative action which would be appropriate would be to impose a cut-off date. Generally this provision runs counter to the ISDA "Second Method" approach. However the "flawed asset" approach is used as an additional protection by brokers in jurisdictions in which the enforceability of the close-out netting provisions are uncertain.

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

In principle, yes. Please note that we do not agree with the statements made in Box 7.B in relation to the different approaches to close-out valuations under the 1992 and 2002 ISDA Master Agreements. The majority of our members used the 1992 valuation methodology in the LBIE default and the close-outs occurred more or less smoothly. The statements in the first paragraph about the comparative merits of the two does not reflect market practice as in nearly all 1992 ISDA Master Agreements parties elect to use "Market Quotation" and not "Loss" which you refer to as the "method of loss calculation". Many of our members decline to transact under the 2002 Master Agreement on the basis that it leaves too much discretion to the counterparty in the event of close out and is potentially unfavourable to them.

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?

No.

83. In relation to the areas listed here, 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?

We cannot currently identify any.

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 here and which the Government should consider?

We cannot currently identify any.

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Ladies and Gentlemen

Establishing resolution arrangements for investment banks

The International Swaps and Derivatives Association (**ISDA**)[1] is grateful for the opportunity to respond to HM Treasury's consultation document "Establishing resolution arrangements for investment banks" (December 2009) (the **Consultation Document**). As you know, we responded to the Treasury's earlier (May 2009) consultation on investment firm resolution issues, and we have participated and continue to participate in the on-going consultations conducted through your Investment Firm Advisory Panel and its working groups. We are grateful for the opportunity to represent the views of the privately negotiated (or over-the-counter (**OTC**)) derivatives industry in those discussions.

1. Scope of the Consultation Document and our response

The Consultation Document addresses a wide range of issues of interest to our members, particularly those carrying on business as investment firms established in the UK and those dealing with UK investment firms. As we are primarily concerned with the derivatives sector of the financial markets, we will focus in this response on the issues raised in chapter 7 of the Consultation Document that relate directly to the OTC

[1] ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit and equity swaps, options and forwards, as well as related products such as caps, collars, floors and swaptions. ISDA currently has more than 840 member institutions from 58 countries on six continents. More than half of ISDA members are based in the European Union and neighbouring countries and most of the other members are active participants in the European financial markets as dealers, service providers or end users of derivatives. Promoting legal certainty for cross-border financial transactions through law reform has been one of ISDA's core missions since it was chartered in 1985.

derivatives market. We note, in fact, that some of the points raised in that chapter are specifically directed to ISDA for consideration, as discussed further below. After addressing the issues raised in chapter 7, we will briefly discuss some of the other issues raised in chapters 2 to 6 and 8 of the Consultation Document that are of particular importance to the derivatives market, for example, on the question of "rehypothecation" (right of use) of client assets.

We are aware that other UK, European and International trade associations will be commenting in some detail on the issues raised in chapters 2 to 6 of the Consultation Document, and in some cases we have had the benefit of reviewing those responses in draft. For example, we have had the opportunity to review a near final draft of the response of the Association for Financial Markets in Europe (**AFME**). There is a strong overlap between the membership of AFME and our membership, and their response will undoubtedly have the support of our members on the broader issues.

We have also reviewed a near final draft of the response of the Insolvency Law Committee of the City of London Law Society (the **CLLS Insolvency Law Committee**). Several of the law firms represented on the CLLS Insolvency Law Committee are also associate members of ISDA. We defer to the legal experts on that committee as to the detail of their response and believe that their core conclusions are supported by our broader membership.

Finally, we have seen the response dated 5 March 2010 of the European Repo Council of the International Capital Market Association (the **European Repo Council**) in relation to the repo market questions in chapter 7 of the Consultation Document, and we make further reference to it below.

2. Chapter 7 of the Consultation Document

Section 2(a)(iii) of the ISDA Master Agreement

Paragraphs 7.5 to 7.14 set out a balanced summary of the issues raised by the Lehmans case in relation to Section 2(a)(iii) of the ISDA Master Agreement. ISDA welcomes the acknowledgement of the purpose and importance of Section 2(a)(iii).

ISDA believes that recent events, as well as the recent decision of the High Court in *Marine Trade SA v Pioneer Freight Futures Co Ltd BVI* and the *Metavante* decision in the US Bankruptcy Court, justify a review by its members to ensure that:

(i) the protection Section 2(a)(iii) offers to non-defaulting parties is preserved;

(ii) potential drafting ambiguities in Section 2(a)(iii) highlighted by the *Marine Trade* case are addressed, if necessary, in order to clarify the intended effect of the provision (acknowledging, however, that market participants may have different views on the correct interpretation of Section 2(a)(iii) which may, in some cases, differ from the *obiter* view of the judge in *Marine Trade*); and

(iii) Section 2(a)(iii) operates in the manner intended, it being acknowledged, as noted in paragraph 7.9 of the Consultation Document, that it is not intended to operate as a 'walkaway clause'.

Question 80: ISDA strongly agrees that neither a regulatory nor a legislative solution is necessary or desirable if a suitable market solution is reached. ISDA is committed to working with its members to work out such a market solution, preserving the protective effect of Section 2(a)(iii), particularly at the time a default occurs and during its immediate aftermath, while addressing the issues highlighted by recent market events.

Close-out valuations and a resources centre for liquidators/administrators

Paragraph 7.15 and Box 7.B are a fair summary of the current position in relation to close-out valuations. The market has focused a great deal of attention on these issues in recent years, as reflected in the "Close-out Amount" definition of the 2002 ISDA Master Agreement.

Current difficulties faced by liquidators and administrators in assessing close-out claims are, in some cases, due to lack of sufficient expertise to assess those claims. The development of a resources centre along the lines suggested by the Treasury in paragraphs 7.16 to 7.23 of the Consultation Document could perhaps help to ameliorate those difficulties, although that would depend on the precise nature and content of the resources centre, the availability of appropriately qualified risk managers and so on. We are aware that some respondents to the Consultation Document, in particular, AFME, (i) are sceptical whether a resources centre could be maintained at negligible cost (as suggested in the Consultation Document), (ii) believe that it would be difficult to keep the resources centre up-to-date and therefore relevant and effective to address close-out valuation issues and (iii) question whether such an undertaking should be funded out of public resources.

It may be that the real problem is not lack of appropriate resources. (We understand, for example, that the Lehman administrators have a significant number of appropriately qualified staff available specifically for the purpose of evaluating counterparty claims relating to close-out of OTC derivatives and other financial market positions.) Differences may arise between close-out valuations determined by creditors and close-out valuations determined by administrators for the same positions due to differences in valuation models and techniques used on each side. This is inevitable given that different market participants develop and employ different valuation models and techniques. The freedom of market participants to do so is essential to competitive and efficient markets.

We would therefore question whether the difficulties described in the Consultation Document are attributable to a lack of appropriately skilled resource or instead to valuation difficulties arising, for example, in relation to: (i) structured rather than “flow” (standardised and relatively high volume) products; (ii) transactions considerably larger or smaller than the average size traded on the market for the relevant product type; (iii) products for which there is no active secondary market or for which the market is illiquid; and (iv) products for which the related underlying market is distressed. By its nature, the

OTC derivatives market includes products or transactions that are not standardised but are instead customised to meet specific requirements of particular counterparties, for whom no standardised product or transaction in the flow market is appropriate. The valuation of customised transactions will not always be straightforward, and there may be differing views as to how such valuations should be performed and the parameters used to determine such valuations; these will need to be addressed on a case-by-case basis.

It may be, however, that a market solution could be found to ease the difficulties of liquidators and administrators, for example, by standardising the form, content and manner of delivery of OTC derivative close-out claims, in order to make it easier for insolvency officials to assess the claims and therefore to streamline the admission of the claims. It is clear, though, that there is unlikely to be a "one-size-fits-all" solution. The Treasury could encourage market discussions in this area.

It seems unlikely that a regulatory or legislative solution to this specific issue would be feasible, much less necessary or desirable.

Finally, we note in passing that the second sentence of paragraph 2.23 of the Consultation Document refers to the possibility of including provisions in the special administrative regime for financial disincentives if counterparties have provided unreasonable close-out valuations on derivatives transactions to administrators. We believe that this sentence relates to an idea discussed by the Treasury with the Investment Firm Advisory Panel, but which ultimately did not result in a formal proposal in chapter 7. In our view, the idea is not practicable, would be impossible to enforce and would, in any event, not address the close-out valuation issues raised in chapter 7.

<u>Question 81</u>: ISDA believes that the proposal of a resources centre to aid administrators may be worthy of further study, but there are serious objections to the proposal that must be considered. Also, the resources centre would not address the difficulties of reconciling OTC derivatives close-out valuations that have arisen even when (as in the case of the Lehmans administration) there are substantial expert resources available to the liquidators/administrators. An alternative approach to resolving these difficulties may be for the market to consider greater standardisation of the form, content and manner of delivery of OTC derivative close-out claims, in order to make it easier for insolvency officials to assess the claims and therefore to streamline the admission of the claims.

Repo market close-outs

The repo market referred to in the Consultation Document (understood broadly to include the securities lending market), as discussed in paragraphs 7.24 to 7.27 of the Consultation Document, is closely aligned with the OTC derivatives market, and our members are actively involved in it. The repo market as such is not, however, part of ISDA's area of direct focus as a trade association, and so ISDA defers to and supports the views of the European Repo Council and of AFME, each of which is more directly concerned with that market.

<u>Question 82</u>: See above.

Mitigating negative externalities

The issues raised in paragraphs 7.28 and 7.29 of the Consultation Document bring together a number of themes arising in other chapters of the Consultation Document. ISDA has no specific comments in relation to these points, but touches below on some of the themes to which paragraphs 7.28 and 7.29 make reference.

Questions 83 and 84: See above.

3. Chapters 2 to 6

As noted above, as a general matter, the issues raised in chapters 2 to 6 are not specifically derivatives market, although the issues are, of course, important to the derivatives businesses of investment firms and those who deal with them, as they are to other areas of investment firm business. We are aware that you will be receiving detailed submissions on the issues in chapters 2 to 6 from other trade and professional bodies, such as AFME and the CLLS Insolvency Law Committee. We therefore make only a few select observations on points that are closer to our core concerns:

- We are aware that there are differences of view among our members as to whether the case has yet been made out for a special administration regime, special administration objectives or modified liability standards for administrators. The issues and ideas discussed in chapter two of the Consultation Document are certainly worthy, however, of further study.

- We do agree that it is important to determine how a special administration regime for investment firms would work with the special resolution regime of the Banking Act 2009 in relation to any investment firm that was also authorised to accept deposits, and we welcome the Treasury's consideration of this question.

- We do not express a view on whether there should be special regime for post-administration financing (acknowledging, as noted in the Consultation Document, that comparable issues were recently canvassed by the Insolvency Service in relation to corporate insolvencies), but any such special regime should, of course, not interfere with netting, set-off, security or title transfer collateral arrangements or any property subject to a security arrangement.

- We broadly support the proposals in chapter 3 of the Consultation Document, but agree that considerably more work needs to be done on the detail. Any legislative or regulatory proposals to implement these ideas, of course, need to be proportionate and cost-effective.

- We believe that many of the issues discussed in chapter 4 of the Consultation Document may be dealt with by appropriate market action and that the Investment Firm Advisory Panel and its client asset working group could usefully focus on encouraging and providing guidance for such market action. We certainly favour clarity, increased transparency and improved speed of return of client assets. We question whether mandated product warnings in contractual agreements between professionals is necessary. We favour clarity in contractual arrangements, but this should be market-led. Market documentation is regularly stress-tested by events and while stability in standard terms is also important, each new crisis has tended to result in improvements to standard form documents. The 2002 ISDA Master Agreement, for example, reflects the experience of ISDA members of various market events and crises, particularly in the late 1990s, including the Russian moratorium, the near collapse of LTCM and the Asian currency crisis. We are confident that the market has the ability to learn and apply the lessons of the past couple of years to its standard form documents, in the OTC derivatives sector, in the repo and securities lending sectors and in other sectors of the financial markets.

- We welcome the Treasury's acknowledgement in paragraphs 4.19 to 4.23 of the Consultation Document that so-called "rehypothecation" (right of use) of client assets (or more generally assets provided as collateral by a counterparty, who may not be a client in the regulatory sense) can serve an important commercial purpose and that parties should have the freedom to structure their arrangements accordingly. We also agree with the Treasury's view that the legal concepts and rules underpinning the different arrangements outlined, for example, in Table 4.B are relatively clear, even if some counterparties of Lehmans seem either to have been unaware of the credit risk consequences of rehypothecation (or, less charitably, to have taken the credit risk willingly or neglectfully, only to cry "foul!" after the Lehmans collapse). Again, as noted above, where such counterparties are hedge funds or other professional firms, we are sceptical of the need for (and, indeed, oppose in principle) mandated product warnings in contracts between investment firms and professional counterparties.

- In relation to paragraphs 4.24 to 4.28 and related Question 35, we would urge the Treasury to ensure that any UK legislation in relation to shortfalls in client omnibus accounts takes account of the Geneva Securities Convention, to which the Treasury makes reference in Chapter 8, as well as to any European work implementing the recommendations of the European Commission's Legal Certainty Group, which we understand is currently being carried forward in relation to a proposed European securities Directive. This would, we believe, result in a loss allocation rule broadly in line with the recommendation of the Financial Markets Law Committee (**FMLC**) made in its July 2004 report "Property interests in investment securities", to which the Consultation Document makes reference in a footnote to paragraph 4.26.

- We believe that the Treasury is not proposing any change to the legal regime underlying rights of set-off and liens, but clarification of custody arrangements and perhaps changes to related contractual arrangements in order to simplify the analysis of client asset holdings. In answer to Question 46 of the Consultation Document, we think that it should be clear in principle that a custodian should not exercise a right of set-off or enforce a lien against assets belonging to a client to satisfy liabilities owed in a principal capacity by the investment firm dealing with that client. We favour segregation of client assets from house assets of a firm to simplify the process of identifying client assets and facilitate their return. We appreciate that there is a potentially difficult international aspect to this where a UK investment firm uses a custodian in a jurisdiction without appropriate safeguards for client assets. This underlines the importance of the international dimension discussed in chapter 8 of the Consultation Document.

- We believe that detailed and, as far as possible, market-led work on custody and segregation issues could go a long way toward reducing or even eliminating the need for additional special rules or regulatory requirements to facilitate return of client assets, although we acknowledge that some changes to client money and client asset rules and regulatory requirements are likely and desirable to strengthen the existing regime, particularly in light of the December 2009 judgment of Mr Justice Briggs in *Re Lehman Brothers International (Europe) [Client Money]* and, of course, subject to the outcome of the appeal of that judgment.

- Along the same lines, we believe that strengthening the current client money and client asset regime along existing lines, with improved clarity of custody arrangements and related contracts, could obviate the need for the establishment of a client assets trustee (CAT) or a client assets agency (CAA), as discussed in chapter 5 of the Consultation Document. In the meantime, the Investment Firm Advisory Panel should encourage market-led solutions such as the development of bankruptcy-remote third party custodians to hold client assets, as discussed in chapter 5 of the Consultation Document.

- While chapter 6 does not strictly speaking deal with derivatives issues, legal certainty for settlement of equity trades is clearly important for the equity derivatives market, which is closely related to and interdependent with the cash equities trading market. In principle, we support the AFME Protocol for cash equity trades, which we understand is still in development, while agreeing with the FMLC that additional regulatory measures may be needed, as noted in paragraph 6.34 of the Consultation Document, which refers in a footnote to the FMLC paper "Issue 140 – Unsettled OTC Trades" (September 2009). The discussion in paragraphs 6.11 to 6.39 deals with the contractual aspect of unsettled cash equity trades, while paragraphs 6.68 to 6.80 deal with the settlement aspects and specifically the CREST system rules as operated by Euroclear UK and Ireland (**EUI**). These need to be considered together as two aspects of the same problem of unsettled OTC cash equity trades, as discussed in the FMLC paper.

- We also note the importance of the clearing issues discussed in paragraphs 6.40 to 6.67 of the Consultation Document. A great deal of market-led work is currently being done on these issues, and we recommend that, as far as possible, such market work should be carefully considered by the Treasury and the Investment Firm Advisory Panel before deciding whether any further legal or regulatory initiative in this area is necessary. We believe that paragraphs 6.40 to 6.67 set out a useful summary of current issues and areas of focus in relation to clearing.

- Not surprisingly, in relation to the issues raised in paragraphs 6.81 to 6.88 of the Consultation Document in respect of contractual arrangements between investment managers and investment firms, we favour market action and do not believe that the case has yet been made out for UK government action in relation to such contractual arrangements.

4. Chapter 8

We strongly endorse the Treasury's recognition of the importance of international cooperation in relation to cross-border resolution, and we commend the proactive role that the United Kingdom has played in those discussions. In recent months, ISDA has responded to the Basel Committee on Banking Supervision Cross-Border Resolution Group Report and Recommendations and to the European Commission's Communication on Cross-Border Crisis Management in the Banking Sector.[2]

ISDA has for many years focused an important part of its law reform efforts on international initiatives to promote legal certainty in relation to key issues facing the financial markets. ISDA has therefore actively participated in law reform initiatives of the Hague Conference on Private International Law, UNCITRAL and UNIDROIT as well as European and other regional law reform initiatives (as well as in national law reform initiatives, over the years, in dozens of countries around the world). The broader context of financial law reform represented by these other initiatives should not be neglected in the focus on cross-border resolution. Legal certainty is always important for the financial markets, but particularly during times of market stress.

We note that while mention is made in chapter 8 of the Consultation Document of several international bodies, including UNCITRAL and UNIDROIT, no mention is made of the Hague Conference on Private International Law. We would, however, underline the threshold importance of there being legal certainty as to private international law rules governing or otherwise affecting financial transactions, and in this regard would once again urge the United Kingdom to do what it can to bring the Hague Securities Convention (which provides the private international law counterpart to the substantive law principles for intermediated securities laid out in the Geneva Securities Convention, outlined in Box 8.D of the Consultation Document).

We strongly endorse the Treasury's recognition, in paragraphs 8.20 to 8.24 of the Consultation Document, of the importance of cross-border cooperation. In particular, we welcome the Treasury's highlighting, in paragraph 8.24, of the importance of mutual recognition of statutory transfers under resolution regimes of "foreign property" (that is, rights, liabilities and other property of a failed firm that is subject to a law other than the law governing the resolution of that firm).

One of the issues highlighted during the consultation process that preceded the Banking Act 2009 was the issue of foreign property and specifically whether a foreign court would recognise a transfer by the Treasury or the Bank of England, exercising a partial property transfer power under the Banking Act 2009, of a right, liability or other property subject that foreign court's own law. Of course, mutual recognition should only be accorded where the relevant resolution regime provides appropriate protections for creditors and other parties affected by a statutory transfer, either by way of an appropriate safe harbour

[2] Copies of each response are available from ISDA's website at http://www.isda.org.

(for example, in relation to netting, set-off, security or title transfer collateral) or by ensuring adequate compensation. These are not necessarily easy issues, but we endorse the Treasury's view that international initiatives to achieve an appropriate mutual recognition regime should be supported.

We would be pleased to meet with you to continue our discussions with you regarding the issues arising out of the Consultation Document. We look forward to participating in further discussions of the Investment Firm Advisory Panel and its working group on creditor and counterparty issues. We would also be happy, as in the past, to meet with you bilaterally to discuss issues relevant to the OTC derivatives market. In the meantime, please do not hesitate to contact either of the undersigned if we can be of assistance in relation to these issues.

Yours faithfully

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Dear Mr White,

Re: Establishing resolution arrangements for investment banks

In response to the Consultation on on establishing resolution arrangements for investment banks please see below our responses to selected questions:

Q20: Do you agree that investment firm resolution plans can consist of internal actions followed by market-facing actions as proposed above?

We believe that the FSA should not be required to impose a mandatory requirement on asset managers to produce a resolution plan. Such a requirement is more appropriately aimed at institutions such as investment banks which represent a systemic risk to the market, should they fail.

In relation to Phase I regulatory provisions under CASS 6 and 7, and COBS 11 already stipulate the information to be retained by an asset management firm in relation to client assets, and counterparty positions respectively. Pursuant to a firm's ICAAP process, business operations are also assessed.

In relation to Phase II it is hard to envisage a situation where the insolvency of an asset manager would result in the liquidation of portfolio holdings and return of cash to clients. Apart from such liquidation having adverse affects within the market there may be many reasons why clients would not want this to happen from client tax efficiency to preservation of an investment position. Client assets are segregated from the assets of the investment firm. Were the asset management firm to become insolvent, the management contracts would normally be bought by another firm rather than the clients' portfolios being liquidated and the proceeds being returned to the clients.

Q21. What are the obstacles to implementing investment firm resolution plans as suggested in this paper? What policies counld the Government consider to address these, if any?

We believe that the cost of implementation may be an obstacle. However, there is also the conflict that exists between a firm's senior management responsibilities to run their firm and operate under a resolution plan. There should be clear lines drawn within the FSA as to how, why, and by whom such decisions are made.

Q42: Should the Authorities clarify the scope of FSA CF-29 and centralise CASS oversight under one individual?

We believe that the issue of client assets is so important that it's oversight should be centralised to one individual through appropriate clarification of controlled functions. We acknowledge that a review of controlled functions is currently being undertaken through CP10/3: Effective corporate governance.

Q78: Do you believe that Government action is required to address contractual terms issues?

We believe that in relation to whether there is an imbalance between the volume of terms negotiated in contract and what is covered by regulation or market convention, there are a number of noteworthy observations.

Currently the practice in the market is for a broker to issue its terms of business to an investment firm. However, the investment firm will reply to this by rebutting terms or clauses. Should this exchange continue it can may sometimes lead to a lack of clarity concerning the status quo between the broker and the investment firm resulting in a "battle of the forms".

Even where brokers do engage in discussions regarding their contractual terms, considerable legal resource is required to agree even the most basic of terms, for example, agreeing that the investment firm acts only as agent. The resource at both the broker and the investment firm could be more effectively utilised elsewhere if a market convention or code was established dealing with even the most basic of terms.

We believe that there would be considerable benefit from the existence of a market convention or code in relation to terms used.

Q79: If you do believe regulation or legislation to address terms of business between investment firms and investment manager is required, which issues do you think are the highest priority? Which types of measures would best address them?

We believe that there are many terms of business regularly rebutted because they are drafted in favour the broker/dealer and are often factually incorrect in so far as they relate to the investment firms relationship with (i) its clients and (ii) with the broker/dealer. A main aspect of contention is in clarifying that as an investment firm we act as agent and not principal. Others contentious terms relate to events of default, clarification of joint and several liability, client classification, use of third party brokers and responsibility for acts or omissions of

both the broker/dealer and the third party. We believe that a market convention or regulatory re-alignment of the mismatch between the standard of service provided and expected is necessary.

With regard to all other questions we agree with the IMA consultation responses.

Yours sincerely

Adrian Smart
Compliance Director (LGIM)

Establishing Resolution Arrangements for Investment Banks

These comments reflect the views and experience of a lawyer who has had some familiarity with corporate insolvency in the financial services sector and with the problems of insolvent financial institutions. I am less familiar with the overall regulatory treatment of investment firms and it may be that some of my comments fail to take account of regulatory measures which already exist to provide protections for the counterparties of investment firms.

This submission is structured as follows:

- A short Executive Summary;
- An introduction;
- Some general comments;
- Some specific comments on particular paragraphs of the condoc; and
- Responses to some of the specific questions posed by the condoc.

Executive Summary

The condoc is an impressive piece of work and is the result of a very comprehensive consideration of the issues, in particular as they have been brought into focus by the Lehmans case.

Realistically, there will be limits to the extent to which "managing for failure" will ensure a completely smooth path to an eventual resolution.

Whatever legal regime is introduced, administration or liquidation of a complex financial services business is itself going to be complex and protracted, with the likelihood of the need to seek court guidance on difficult or novel points. So one has to recognise that the contribution which legislative reform can offer is worthwhile but nevertheless limited.

At the core of the proposals are a series of possible measures which are designed to offer clients enhanced protection for their assets (including more rapid return of those assets on insolvency of the investment firm) in the event of investment firm failure. That enhanced protection will come at a cost. Ultimately, it must be for the market to decide the limits of what it is prepared to pay for some of these enhanced protections.

As a result of the detailed review which has been carried out, there are a substantial number of proposals. In many instances, each proposal is by itself logical and justifiable. Overall, a question may arise as to whether it is necessary and proportionate to introduce all of them (and to which categories of "investment firm" they should extend). The answer to that may in part depend on arriving at an informed assessment of the cost to the industry of the proposals taken as a whole.

The one proposal which I would single out as deserving further consideration relates to the Client Asset Trustee. If an investment firm fails under the proposed regime, there will, simplistically, be two possible outcomes. Either, as a result of "managing for failure", there will have been a proper segregation of assets, so that it is relatively easy to identify and return client assets (at least so far as concerns "pure custody" clients)[1]. On this hypothesis, the return could be carried out perfectly adequately and promptly by the Administrators (suitably resourced, of course). Alternatively, there will (for whatever reason) be uncertainties as to identification, allocation and ownership similar to those experienced in the Lehmans case. In this situation, it is not clear that the inevitable complications and delays can be avoided or reduced by the existence of a CAT.

Introduction

Many the proposals, and the associated questions, raise practical issues of costs and capital and liquidity requirements, on which I do not feel able to comment usefully.

As to costs more generally, it will be very important to make a reliable forecast of the likely total additional costs, in terms both of capital/ regulatory charges and operational/ liquidity costs, of the new regime proposed, so as to make sure it does not place the London market at a competitive disadvantage to other financial centres.

A number of the proposals may also necessitate substantial changes to systems, so as for example to create more rigorous systems of identification and segregation of

[1] This also assumes no ambiguities in interpretation of applicable rules.

client assets (and possibly between classes of client). I do not feel able to comment on the practicability or cost implications of these proposals.

I may not have correctly grasped the intended scope, within the community of financial services firms, of the proposals. I note that the proposed scope of the special administration regime is more limited than that of other proposals.

General Comments on the condoc

What price client safety?

The condoc recognises that the implementation of its proposals is likely to involve additional costs for affected institutions. Those costs may be of various kinds, ranging from additional capital or liquidity, through increased oversight and internal audit functions, to costs of modifying or upgrading systems. In particular, any unauthorised use of client assets by the institution or any of its agents or subcontractors to provide working capital, however inadvertent or short term, may have to be more severely constrained. Based on the Lehmans experience, institutions may in future need increased levels of liquidity or indeed capital.

It must therefore be expected that, over time, the cost to clients of providing services with the enhanced protections proposed will rise.

It would also seem that some of the proposals will apply to institutions which are incorporated in UK but not to overseas businesses operating in the UK market through branches of institutions incorporated outside the UK. In the absence of international harmonisation, or of moves to establish voluntary equivalent structures by those not technically subject to the new statutory regime, there may therefore be differential degrees of protection, depending on the status of the investment firm.

So clients may in future be able to choose between a regime which is more protective but costlier and a regime which may offer less comprehensive counterparty risk protection. The market may over time establish the acceptable level of premium for enhanced protection.

Transparency as to applicable regimes

If it is correct that in future there may be institutions operating in the London market subject to differing levels of client asset protection, then, at the very least, this may give rise to a need for clear indications to clients, prior to completion of contracts, as to whether the regime (or regimes) ultimately established as a result of these proposals applies or not.

Even in relation to UK institutions, the question may arise as to the need to make clear whether a particular client has contracted out of the enhanced protections (generally or in relation to particular activities). It is evident that a client who is using the institution's prime brokerage services or who consents to rehypothecation or "right of use" arrangements will not have the same level of protection as a "pure" custody client.

The condoc rightly stresses that there may be a need for more information or warnings to be provided to clients.

Need for differentiation of clients?

The Lehman case illustrates that it can be misleading to treat clients as a single group.

Indeed, at the risk of appearing pedantic, it may be necessary to define what is meant by *client* for the purposes of any new legislation (just as it will be necessary to identify which entities rank as "investment firms"). A counterparty may have multiple relationships with an institution, governed by several complex interlocking (or indeed potentially contradictory) sets of legal documentation, with the result that, although the person may have deposited assets with the failed institution, in fact he has no proprietary right to their return, even if he is in a net creditor position. It is facts such as these which add to the complexity and delay of returning client assets.

Perhaps the most disappointed (and surprised) group of Lehman's clients will have been those whose relations were in the nature of "pure" custody, but who will have discovered that their custody assets were (at least from a practical point of view) exposed to the risk of the sheer diversity of Lehmans' other activities, both own account and trading. By contrast, a client who agrees to rehypothecation or "right of use" ought to be aware that he is taking on a credit risk to his counterparty.

The policy discussion may need to consider what is the appropriate degree of protection for different categories of client. It may also lead to a need to require (or offer as an option) compartmentalisation of client assets held on differing bases.

Failure of an entity which is both a deposit taker and an investment firm.

The financial crisis has offered the experience both of collapsing retail deposit takers and of collapsing investment firms. Mercifully, we have been spared the collapse of an institution which was in any major way both a deposit taker and an investment firm. Separate policy initiatives have resulted, so as to enhance protections for counterparties of deposit takers and for those of investment firms. It will be important to make sure that, if ever called upon to do so, these new legislative structures can operate effectively with each other and that any necessary prioritisations are clearly spelled out. I note that the condoc gives some consideration to this in Box 2A (page 28).

Groups of companies: potential tension between legal structure and operational organisation

This point is not confined to financial institutions, but it is frequently the case in large and complex groups of companies that the way they operate (and are funded) on a day to day basis does not necessarily reflect the strict legal structure. Since current insolvency law almost exclusively looks at each legal entity separately, there can be complications in unravelling transactions, particularly where individual companies are being administered under different systems of law and by different professionals, each perhaps with limited access to information.

It may be time to try to create insolvency or rehabilitation regimes focussing on groups, or at least to set down some basic rules on cooperation and information sharing between different estates comprising a single pre-liquidation group. This comment is not intended to discount the initiative which the English courts have to date shown in allowing ad hoc arrangements to be set up to ease cross border co-operation in individual cases.

There may also be a case for looking at this practice (the disconnect between legal and operational structure) as an example of a sort of operational risk for which regulatory capital has to be set aside.

The existence of this practice is of course highly relevant to the proposal for resolution plans contained in Chapter 3 of the condoc. It is not clear to what extent the comments in paragraph 3.5 are indicative of a policy intention to restrict the ability to adopt operational structures which diverge from strict legal entity approaches.

Disclosure and transparency

Some of the proposals, notably in relation to RRPs, would, if ever invoked, entail the firm working discreetly to seek a rescue or, failing that, seeking to ensure the most orderly possible wind down. By definition, this would have to be done without disclosure to counterparties or the market. Consideration may need to be given whether it would be necessary to modify any general rule which would otherwise apply affecting listed companies (or companies with listed securities) to make prompt disclosure to the market of material information or to avoid creating a false market.

Similar contractual issues may arise, for example in terms of representations and warranties repeated on the rollover of loans and other facilities.

Speeding up transaction settlement

One thing which is evident from the facts of the Lehman case is that any measures which can be taken to accelerate finality of settlement of transactions is to be welcomed and will be beneficial in dealing with the estate of a collapsed investment firm.

Sub custody arrangements

The Lehman case also sheds light on the risks which can arise when the requirements which should apply as between an institution and its client turn out to be inconsistent with the contractual arrangements entered into between that institution and a third party dealer or custodian in order to give effect to the client's instructions as to the purchase or holding of particular securities. This can only be resolved in a completely satisfactory manner at an international level, but it is desirable to reinforce requirements for institutions to ensure the segregation of own account from client dealings with their own counterparties.

Rights of Use, Rehypothecation and stock lending

It is very important that counterparties should be aware of (and indeed consent to) transactions such as rehypothecation and stock lending, and understand the associated risks. Clearly if a client is also a borrower, then rehypothecation may be a fair "price" for the facilities offered by the investment firm.

An insolvency of an investment firm is likely to show up the risks for counterparties in allowing "rights of use" or rehypothecation of securities subject to collateral or repo arrangements. It may well be that the market becomes more cautious about what has in recent years become an accepted practice in the London market, particularly after a number of legal uncertainties were dispelled. This may also be an area for regulatory guidance, at least at the level of requiring clear information and risk warnings.

Review of the FSA CASS Rules

It may well be that the outcome of some of the issues which are or have been before the courts arising out of Lehmans (and other) cases will lead to a review of the CASS rules. The completion of the review may have to await the outcome of any appeals, which clearly has timing implications. Any such review may have to operate in tandem with the proposals in the condoc. To an outsider reading the comments of the court in the Lehman case[2], it seems surprising that the firm itself (and to some extent presumably its regulator) could have been able to misinterpret to a significant degree the requirements of the CASS rules.

The Financial Services Compensation Scheme

As and when the impact on the FSCS (and the allocation of compensation costs among those who fund it) of the insolvency of Lehman (and other investment firm insolvencies) is clearer, it may be necessary to review its operation and ascertain if there are any lessons to be learned.

The international Dimension

There are international implications to some of the issues under consideration. For example, some of the proposals interrelate with the structures established by MIFID. In addition, there are hints in various places that initiatives which may on

[2] [2009] EWHC3228 (Ch), as supplemented by [2010] EWHC 47 (Ch).

their face seem sensible and attractive may have as an unfortunate consequence that London could lose out to other international centres.

Specific Comments on Chapters of the Condoc

Set out below are some comments on the text of individual chapters of the condoc. These should be read in conjunction with the answers to specific questions posed by the condoc, which are contained at the end of this document.

Chapter 1: Introduction

Paragraph 1.23 suggests adopting the MIFID definition for the purposes of identifying which legal entities will be subject the regime proposed (although, as I understand it, the ambit of the "special administration regime" may be more circumscribed- see paragraph 1.25). However, that definition seems very broad and could, for example, apply to many very small entities in relation to which some of the mechanisms proposed might arguably be disproportionate. At the very least, there may be merit in drafting the legislation so that particular categories of activity could be excluded by secondary legislation.

Chapter 2: Enabling an orderly resolution

It may well make sense to adopt Special Administration Objectives for investment firms, although the objectives proposed may in practice reflect what an Insolvency Practitioner would do.

The main point which may be unclear is whether there will be a category of legal entities which are both deposit takers and investment firms, in which case it will be desirable to have clarity as to which of the special regimes apply and the prioritisation of objectives overall.

With regard to the general question of administrator liability, it would seem implausible that an administrator could be held liable for carrying out the statutory objectives for which he was appointed. The main real risk in circumstances such as this arises out of the need to take decisions on the basis of inadequate information (or, as explained elsewhere in the condoc, without access to expertise of a particular kind), recognising that doing nothing could be as damaging to the estate and its counterparties as following a course of action which may, with hindsight, be perceived as less than optimal. Administrators should certainly not find themselves in a situation where they are paralysed until they have perfect or complete information. However counterparties may themselves feel starved of up to date information.

Chapter 3: Requiring firms to manage for failure

Whilst recognising that this is only a title, the concept of "managing for failure" seems a little extreme, since any flourishing enterprise needs to operate in an optimistic and innovative culture which manages "for success". Perhaps the right (if long-winded) emphasis is to "manage taking due account of all the risks and alert to the possibility and implications of failure".

Paragraph 3.13 contemplates that the new role of BRO could be assumed by an existing executive member of the board such as the Chief Operating Officer. There are clear merits in this approach, both because of the familiarity which such an officer will have with the firm's business and activities and in terms of avoiding excessive additional costs. However, if the RRP ever has to be implemented, there is likely to be a huge effort required of the BRO at a time when potentially, wearing his other hat, he will also be overwhelmed by decisions and activities aimed at averting crisis. So, at the very least, there may need to be some back up resources to call on to support the designated BRO.

It also needs to be recognised that, when a firm is encountering difficulties, there could be tensions between differing objectives. An obvious example is the impact of a sale (and in effect rescue) of part of the business on the ability of the reduced remaining business to implement a RRP.

It may well be in practice that involving the personnel of the putative Administrator firm at an early stage, or retaining other professionals familiar with turnaround in the financial services sector, will provide the practical solution.

Paragraphs 3.70 to 3.76: it is not entirely clear from an insolvency law point of view how this would work. Paragraph 3.73 talks of funds being "ring fenced". On the other hand, paragraph 3.76 says "On insolvency, the assets would be part of the general estate of the firm to be distributed according to the insolvency rules". If the latter is the case, it is hard to see how an administrator could properly use the funds in a manner which would prefer a certain category of creditors (administration suppliers). (Perhaps the reference to insolvency is intended as making a distinction between administration and liquidation.) The funds would need to be subject to a statutory segregation mechanism (if not a formal charge or trust) under which they can only be used for the administration purpose and not available to general creditors.

Chapter 4: Reconciling and returning Client Property

It may not be possible to make definitive decisions on the reforms necessary in this area until the courts have finally pronounced on any appeals in the client asset and client money cases arising out of the Lehmans collapse.

However it is already evident that greater clarity may be required:

- As to the legal/ regulatory rights and obligations of the investment firm and individual clients;
- As to the effect of the (often complex and detailed) contractual arrangements put in place between the firm and its customers and in particular the consequences of the firm having powers to use or deal in client assets deposited by or held for clients;
- As to the impact of a firm using a third party (including an associate or a third party overseas) to hold the client's assets; and
- As to the impact of the mixing in a single account of more than one client's assets.

From a regulatory perspective, there may be a case for greater explicit notifications to (at least some categories of) clients.

There may also be a case for applying segregation not just as between client and firm assets, but as between the assets of different categories of client, the most obvious argument being for total segregation of assets belonging to "pure" custody clients. Clearly there may be cost implications of the enhanced protection that would provide.

Chapter 5: Client Assets Trustee and Client Assets agency

Although the views of Insolvency Practitioners will be the most influential in deciding whether creating the concept of Client Asset Trustee is likely to be valuable, it is not immediately evident that creating a CAT will of itself expedite the process of returning client assets.

As implied by the report, it may be that what will in practice make a rapid return most achievable will be the practices, including record keeping, followed by the institution in question prior to its failure.

I strongly agree with what is said in paragraph 5.37, both in policy terms (the main focus should be on imposing and enforcing a more rigorous regime in relation to client assets) and in terms of the foreseeable practical outcome of such an enhanced regime. Moreover, I doubt whether the existence of a CAT will significantly speed up return of assets in a situation such as the Lehman case.

In reality, in a large and complex case, the firm of insolvency practitioners appointed (and indeed their legal advisers) will establish a dedicated team to focus on and find solutions to specific client asset issues.

The principal doubts I have as to the effectiveness and value of a client asset trustee are as follows:

- If the difficulty of dealing with and returning client assets relates to any of the following, namely:
    - Working out if a particular counterparty is a "client" (as opposed to a debtor);
    - Uncertainty as to the scope of collateral or rehypothecation arrangements;
    - A shortfall in overall assets of a particular designation;
    - Complexities with subcustodians or other group companies;
    - Uncertainty associated with transactions not having been closed out,

  then, ultimately these are legal or factual problems which have to be resolved. Both the administrators and the CAT have to be involved; there is clearly scope for duplication. Third parties may be confused by having two officeholders making similar enquiries. It must surely be more efficient for a single office holder, owing impartial duties to clients and creditors, to carry out these reviews and form conclusions, if necessary, with the assistance of the court.

- There may actually be scope for increased disputes. Given the duties of the CAT and the scope for ambiguity as to the precise impact of complex and intertwined documents on particular transactions of relationships, the CAT may feel obliged (or be pressed by his committee) to test issues in court.

- There may also be issues of general application which will in practice need to be dealt with through a single decision applicable across the estate. Examples thrown up by Lehmans are the currency of denomination of the overall accounting and the date as at which consequent currency conversions are made. This argues for a single "plenipotentiary" officer holder, subject of course, to the guidance or supervision of the court where appropriate.

It has in particular to be recognised that many clients may also be borrowers or other counterparties of the failed institution, rendering the process of returning assets more complex.

Accordingly, whilst the concept of a CAT may be useful in particular circumstances, it would not be desirable to mandate this in all cases where an institution holding client assets fails.

Turning to specific paragraphs of chapter 5:

Para 5.3: The relationship between the CAT and the administrator seems to be very complex. There will be a general and reciprocal duty to co-operate and share information. On certain matters, the CAT can act without the consent of the administrator (although after consultation) and on others, as here, express consent will be required. Whilst these subtleties are justifiable, they may not be conducive to achieving speedy or cost effective resolution of points of difficulty.

Para 5.4: This is couched in terms of a binary divide between *creditors* and *clients* but often the key issue is whether the counterparty is, in overall net terms, a client, a creditor or a debtor. Bearing in mind the preponderance of "Master Agreements" (some of which purport to regulate a counterparty's relationships with all companies in a financial group), in a complex case it may take a while to answer this seemingly simple question.

The second bullet in this paragraph refers to something which "the administrator cannot do at present". I assume this is a reference to prioritisation. I am not sure that this is strictly correct, but in any event, as I understand it, the proposed special insolvency regime will clarify matters.

Para 5.5: The CAT probably does need to be an Insolvency Practitioner. There seems no reason in principle to impose a requirement that the CAT comes from a different firm, which could, as indicated elsewhere, only complicate matters. It may be that the professional conduct rules of professional bodies will need to be modified to make clear that the administration does not constitute a “material professional relationship” precluding acceptance of the CAT role.

Para 5.6: If the CAT role is created, it is desirable that as much discretion is built into the legislative framework as possible, to avoid it being mandatory in any particular case but to allow its adoption whenever it might be useful to the administration of the estate.

Para 5.8: The proposal as to proportionate releases may raise practical complications for as long as amounts owed between the insolvent and its counterparty are not finally determined, especially if contracts have not been closed out or there are issues such as currency fluctuations to deal with.

Para 5.12 and 5.13: I may not have understood the first alternative in 5.12. I read the reference to assets “vesting in the CAT **personally**” (emphasis added) as precluding any trustee status of the CAT, but the final words of the second bullet may imply the CAT would be a trustee.

Both alternatives seem rather complex. Surely all that is required is that the CAT should succeed to such legal title and associated rights to client assets as the failed institution had immediately prior to his appointment?

Para 5.15: The power to impose a Bar Date would obviously be useful, although it is noted that the courts have shown they have the power to impose a Bar Date. Any mechanism to impose a Bar Date will necessitate liaison with the Administrators and to build in power for clients to make representations as to the proposed Bar Date. There can of course only be one Bar Date.

Para 5.18: The case of rehypothecation, which entails absolute title transfer and not just the creation of a security interest, will also need to be dealt with. This may also be complicated if contracts have not been closed out.

Para 5.19: This demonstrates the interdependence of the CAT and the Administrators.

Para 5.20: How easy this is to achieve will depend on how much complexity there is around client assets and any shortfalls as well as being able to be certain who is unquestionably a net creditor. Any CAT carrying out this function will be heavily dependent on availability of information from the Administrators.

Para 5.27: This may be counterproductive, since if the CAT has an indemnity out of assets, he will be reluctant to release them; correspondingly, to the extent he hands assets back, his indemnity will become reduced in value. The solution may lie in ensuring a suitable limitation of liability (including as to general trustee duties) absent gross negligence or worse.

Para 5.29: Unfortunately it cannot be assumed that complexity will be reduced.

Para 5.30: The court should have power to determine a fair allocation of costs. It cannot be assumed that a rigid rule of allocation of costs to interests represented would always be fair.

Para 5.32: It is hard to be certain that any one hard and fast rule will be fair in all situations. This may be something which the court or a suitably experienced impartial assessor should have power to determine.

Para 5.36: The ability of the Lehmans Administrators to establish a Bar Date through the general power of the court shows that the combination of existing law and the court's inherent powers can work to produce solutions.

Paras 5.39-5.58: I do not feel in a position to comment usefully in relation to the proposals for the establishment of a Client Assets Agency. It is clearly desirable in future to dedicate increased regulatory resource to the supervision of client assets and clearly the CAA is one way of achieving this.

It may also be desirable to clarify and reinforce the CASS rules (and, going forward, a decision would need to be made as to who has "ownership" of the CASS rules).

If a CAA is established, it should have power to be involved in the activities of any CAT who is appointed. However any CAT appointed must exercise his functions as such independently of the CAA, even if that means in a particular case challenging the interpretation adopted by the CAA of applicable rules for which the CAA has ultimate responsibility.

Irrespective of the existence or otherwise of the CAA, the skill sets, experience and resources required to perform the CAT role suggest that it would make sense, at least in complex cases, to have an Insolvency Practitioner as the CAT.

A final point which may merit consideration is the extent of the relationship between the CAA and the FSCS.

Chapter 6: reconciling Counterparty positions

Many of the issues raised are somewhat technical and I do not feel that I have anything particular to contribute. I will therefore confine myself to the following comments:

- Much may in practice depend on what degree of protection or flexibility underlying clients wish to have and how much they are prepared to pay for it (recognising that some features may only be cost effective if a sufficient volume of clients commit to buying in to them), so the principle of a client's fully informed freedom of choice seems a sensible starting point. Evidently, additional considerations would apply in the case of non sophisticated clients;

- Making a clear distinction, recognisable to all persons participating in transactions, between an institutions' own account and client transactions (even if the institution may be liable as principal to the counterparty on the client transactions) seems an attractive proposition, but may prove more problematic (or expensive) in practice;

- It is clearly important to make sure that what is actually done with what are client assets (in terms, for example, of providing margin to central counterparties) is consistent with what is permitted by CASS rules;

- Part 7 is itself very technical and the drafting in part reflects the "state of the art" as it existed when the legislation was last modified. It is clearly sensible both to take this opportunity to review and update it now in the light of more recent experience and to make sure that this monitoring is maintained on a regular basis. The same applies, at a European level, to the Settlement Finality Directive;

- Extending Part 7 protection to underlying client trades may prove quite complex, if the result is that some of a client's relations with the failed institution have part 7 protection and others do not;

- The "battle over forms" relating to terms of business is an important issue and it is inherently unsatisfactory for both parties to enter into a transaction or a relationship without knowing what key contractual terms may be. This is not necessarily an issue where there is a single a correct answer; overenthusiastic drafting from each end of the spectrum, as well as highly complex master agreements, may exacerbate the issue. Whilst the authorities may have a useful role to play in encouraging the search for a fair "Third Way", it seems unlikely that there is a single rule which will apply fairly to all situations.

Chapter 7: Managing complex creditor positions

One general point to make in relation to this discussion is that it shows how difficult it is to make any clear distinction between "clients" and "creditors". Some clients will turn out to be creditors and not to have any benefit from CASS rules or general trust law principles. Moreover the nature of a client's actual enforceable rights (ignoring the illusory value, in the circumstances, of claims for breach of contract or of trust) will depend as much on how the failed institution conducted business prior to its collapse as on the regulatory regime to which it was subject. This may reinforce the need for enhanced monitoring of institutions in "going concern" mode.

The existence of client asset rules, together with other special factors such as the greater ease of creating collateral under the Financial Collateral Directive, inevitably means that those creditors who are unsecured are less privileged than those who are protected by these special arrangements. The insolvency regime should not of itself seek to undo this, although it is recognised that there is a case for trying to avoid exacerbating the subordination of unsecured creditors as a result of the sheer complexity of handling "secured" creditor positions.

What is important is that clients should know, when they are entering into relations with a financial institution, what their status will be and to what extent protections should be available.

There may also be issues as to the extent to which institutions should be able to contract out of client asset protection regimes when dealing with certain categories of client.

One of the most delicate issues which arises in this area relates to whether there should be less flexibility for non-defaulting counterparties of insolvent institutions to decide whether or not (and when) to terminate or close out contracts which remain in effect as at the time of insolvency. As the condoc notes, typically the institution's insolvency will give the counterparty the contractual right (but not the obligation) to terminate; provided that the counterparty continues to perform (subject to the effect of suspension clauses), the right may continue indefinitely for the duration of the contract. Freedom of contract is an important and desirable principle and it is unattractive to infringe or restrict it unduly, particularly as against the "innocent" party. In addition, termination as at the date of the insolvency may create additional anomalies, as the institution's insolvency may itself throw up market distortions or volatilities which make any valuations or loss calculations problematic or exaggerated. At the very least, a counterparty should be given the time, post insolvency, and following (some degree of) market stabilisation to seek to put in place substitute contracts. It may be that a way forward might be to extend the Bar Date concept to create power for the administrator (with or without court leave) to set a date during the administration by which a counterparty's claim must be valued. Another approach to examine might be to make clear that the creditor claim in the administration or any subsequent liquidation be linked to hypothetical valuations as at a particular date (or an average over a period), even if the contact is not actually terminated.

On the specific subject of suspension clauses, past experience has indicated that the precise effect and consequences of such provisions may not always be clear and there may be merit in considering expanding them to indicate more precisely how they are intended to apply either generally or in particular cases.

Chapter 8: Working towards cross-border resolution

As the condoc notes, a considerable degree of cross border co-operation, if not harmonisation, is desirable. This is particularly important if some of the proposed new UK legislative measures will only apply to companies incorporated in the UK and so not extend to branches of overseas Institutions operating legitimately in the UK marketplace.

With very few exceptions, insolvency law both generally and in the financial services sphere looks at each individual legal entity separately (even if there may be special rules affecting transactions between group members). Increasingly, however, complex international groups (financial or otherwise) adopt operational structures (for example in relation to group treasury) which do not necessarily reflect the legal structures. Further, counterparties may not always focus on precisely which legal entity in a group they are contracting with, whereas many large investment firms may attempt to impose on their clients master agreements which are designed to protect the dealings of every group company with that counterparty. Although this may be somewhat beyond the scope of the current review, there is a case for a study as to whether any new measures are called for to facilitate the operation of restructuring and insolvency procedures to groups of companies. This may be a topic which will be examined as part of the scheduled review of the EU Insolvency Regulation.

It is evident that there are many initiatives under way at international level and it is to be hoped that the existence of multiple fora in which these discussions take place do not preclude full exchange of information between the different bodies and a sensible allocation of responsibilities.

One point not discussed but which has in the past at times been seen as a complicating factor is the existence of provisions in domestic law of some jurisdictions which, in effect, give a measure of priority to domestic creditors or depositors. A general principle of non-discrimination is desirable.

Another mechanism which may need to be looked at in the international context is how different client compensation schemes (corresponding to our FSCS) operate across different jurisdictions.

Comments on specific Questions posed by the condoc

Question 1: See comments on paragraphs 1.23 and 1.25 (page 8 above).

Question 2: Broadly I agree.

Question 3: Administrators are officers of the court performing a responsible function in circumstances where, in the interests of rehabilitation or a better overall result than liquidation, creditors' rights are restricted. It is right that Administrators should be held to stringent standards. It is also important to ensure a fair balance between the rights and responsibilities of Administrators and those of the estate creditors. In this connection, it has to be borne in mind that the law gives administrators, to the potential detriment of individual creditors, valuable powers, such as the moratorium on creditor action.

If, however, a concern about personal liability (for example arising out of the risks of acting on imperfect information) is systematically getting in the way of an efficient and expeditious administration of estates, it may make sense to clarify the scope of liability of an administrator in these circumstances.

It may also be worth considering whether additional powers for administrators to go to court for directions are called for. The English courts are very willing to provide assistance to office holders when the courts have powers to do so, although they have rightly tended to date to take the position that purely commercial decisions are best left for the officeholders themselves to take.

Whether additional powers to restrain creditors are required is a more delicate issue, particularly without knowledge of exactly what is proposed. Time limits on creditor claims could be problematic unless linked to supply of information from the estate to creditors.

Question 4: I question whether the equation between directors' responsibilities and administrators' liabilities is a helpful one, since they are performing very different roles, albeit in both cases usually in a representative capacity for the company. Whilst, at a conceptual level, I can accept that it would be harsh, other things being equal, for an administrator to be liable in circumstances where a director would not be, I find it difficult to envisage the sort of situation where this might in practice occur.

Question 5: See also answer to question 3. There are already wide powers to seek directions. If cases to date have thrown up examples where these powers are inadequate, then perhaps they could be expanded. However, such a procedure might lead to more, not less, litigation. An expedited process seems potentially unfair, since it is only reasonable to deprive a creditor of his subsequent right to complain if he has had time, on a fully informed basis, to consider the implications of what is being proposed.

Question 6: Paragraph 2.35 could be interpreted as indicating an objective to "reduce the number of actions brought by creditors, which have the ability to disrupt the entire process". This seems to imply that any creditor action is without merit. The mere fact that it may be disruptive does not invalidate it. There have been cases in large insolvencies when creditors may have felt that commencing an action has been the only way for them to get heard.

If one takes the Lehman case as an example, you could say that the position the LIBA took in relation to the proposed scheme of arrangement was "disruptive", but their position was shown to reflect the current state of the law. Similarly, the Lehman client monies and assets cases have been necessary in order to clarify what the legal position is.

That is not in itself a sufficient reason for reducing creditors' rights, particularly as the administration process in itself abrogates or suspends many rights. What is really important is to ensure (through use of assigned judges and expedited appeals for example) that any issues which have to be resolved can be dealt with expeditiously.

Further, as a matter of principle, it is unclear why a creditor of an insolvent investment firm should be in a weaker position than a creditor of another insolvent counterparty.

Question 7: I doubt if this is strictly necessary. The real risk associated with wrongful or fraudulent trading is where directors refuse to face up to reality and the inevitability of an insolvency filing. It is extremely unlikely that directors who face up to the actual insolvent situation of the company and who decide to take a few days longer before commencing formal processes would be held liable simply as a result of the delay, particularly in a future regime where the statutory scheme places an emphasis on an orderly handover of functions from directors to the administrators. There could, however, be disclosure duties to consider (see page 6 above). Any handover to insolvency professionals should in any event be smoother if the proposals discussed in chapter 3 are implemented.

That said, the special defence proposed is unobjectionable, to the extent it reflects a common sense approach to the practical application of section 214 and the "taking every step" defence.

Question 8: Taking away an unpaid creditor's ultimate sanction against a "going concern" company, namely the power to request the court to make an order to place the firm into insolvency, is a major step and can only be justified on the grounds of the importance of the firm or its complexity. It must be questionable whether it should apply across the board. If the restriction on "disruptive" petitions by creditors is to apply to all firms, then there will need to be protection from spurious defences which invoke the resolution plan as a way of buying time or fobbing off creditors.

In this context, it may well be worth studying the facts surrounding the recent case involving E Clear[3] to see an example of a situation where creditor action was necessary and justified to bring clarity and finality to a situation which might otherwise have remained murky for a considerable period.

Question 9: There is no easy answer to this and it is noted that the government has recently concluded, in the context of insolvencies outside the financial services sector, not to make changes to the law to facilitate debtor in possession financing. With investment firms the policy and fairness issues may be even more acute. A problem in the case of an investment firm is likely to be imperfect knowledge (although some of the condoc proposals may assist in ensuring the administrators are better briefed on appointment). There may also be an element of having to make a judgment on the evolution of asset prices. If anything can be done to avoid

[3] Although not itself (as I understand it) a regulated financial services firm, it seems to have operated on the fringes of the financial sector and the eventual study of its operations and demise may raise questions as to whether such intermediaries should in future be subject to some degree of regulation.

a “firesale” to generate liquidity, this is desirable. Such funding would in practice have to have superpriority and it cannot be ruled out that hindsight might demonstrate that other creditors suffered from the need to service this new debt.

It may be worth reviewing experience of backstop liquidity facilities established in connection with some securitisation structures. My impression is that these have not always operated in the manner which had been anticipated. Similar complications might arise in relation to any attempts to establish facilities in advance of a resolution trigger.

Question 10: I do not feel in a position to comment on this question.

Question 11: It is quite difficult to answer this in the abstract, as much will depend on the mix of business of the affected institution, its group structure and international reach.

Question12: I do not feel in a position to comment on this question.

Question 13: There is clearly a disclosure issue here, if potential counterparties will be dealing with some institutions covered by the enhanced arrangements and some institutions not so covered.

However this is not just a question of willingness to “contract in” on the part of the overseas institutions: an entity may desire to be subject to the enhanced arrangements but find that the arrangements are incompatible with the mandatory insolvency regime to which it is subject under domestic or EU law.

For overseas institutions, there may also be issues arising out of the base currency which would be used in any insolvency procedure under their home system of law, which may diverge from the currency in which a counterparty’s loss is most readily expressed.

Question 14: A detailed review of applicable overseas legal systems would doubtless throw up a number of issues. In the case of branches (subject to applicable EU Directives in this sphere) and indeed of the multiple companies in a financial services group, it must be assumed that there may be concurrent insolvencies under multiple and divergent systems of law.

One obvious source of friction is the power for some systems of law to prefer their own nationals (however defined). It is noteworthy that the condoc stresses the equal treatment under English law of all creditors, irrespective of nationality.

Question 15: In the interests of certainty and of avoiding excessive complexity, an additional SRR regime should only be introduced if there is a compelling case for it. Whilst it is of course desirable to create structures designed to mitigate the effects on counterparties of investment firm failure, the consequences of such a failure may be less systemic than in the case of a large bank. The challenge may be to arrive at a suitably circumscribed definition of investment firm to which any special insolvency regime will apply.

Questions 16 to 18: See comments concerning paragraph 3.13 above (page 9). The practical difficulty will doubtless relate to proportionality (and consequently expense) as well as prioritising the functions of the person designated as BRO, in the sense that no business will be run on the basis of likely or imminent failure and so the BRO role, while significant, may in practice be subordinate to the day to day commercial strategies, activities and objectives of the firm.

In practice, what may be required would be a standing “business resolution committee”, comprising representatives of the key functions whose skills and know-how would be required in order to implement an orderly restructuring or wind down of the firm’s activities. There may already be some experience of similar committee structures in connection with investment firms’ contingency and emergency planning arrangements.

It is difficult to assess at this stage whether it is necessary both to have the requirement of RRPs and to introduce the separate concept of a BRO. Presumably the board of directors of an investment firm will have a collective responsibility for the viability of any RRP the firm produces.

As the condoc acknowledges elsewhere, there could be special issues where a firm operates in the UK market through the branch of an overseas institution. Similar issues may arise where a company is in practice part of an international and interdependent group.

It is not entirely clear whether in practice all firms, however small or specialised, will be required to prepare RRPs.

Question 19: I do not feel in a position to comment on this question.

Questions 20 and 21: There are a number of obvious issues. The first is whether in practice it is possible to make a distinction between “internal actions” and “market facing” ones. Secondly, some of the internal actions may have significant “knock on” effects. For example, one might expect a cessation of rehypothecation to lead to a need for the firm to have increased liquidity. Actions such as returning client assets will at the least give rise to questions and might be interpreted by counterparties as a sign of trouble, so may precipitate a crisis. It may then be too late to carry out effective ring fencing, both for practical reasons and because of concerns that the interests of one group of creditors are being preferred to those of others.

See also my comments about disclosure obligations on page 6.

Clearly at this stage of a process, there would be a need for intensive practical involvement on the part of the authorities.

Question 22: I do not feel in a position to comment on this question.

Question 23: The initial establishment of a RRP could be a major project for a complex firm or group and may entail formalisation or documentation of currently informal intragroup support or operational arrangements. Whilst this is not necessarily a bad thing, it is an indication of the potential scale of the task involved in creating a firm’s first RRP.

As already indicated, it is likely to involve additional workload, not just for the designated BRO but across a number of important functions within the firm.

Moreover, successful businesses are dynamic, in terms of the markets they operate in, the mix of activities they engage in and also in terms of how they operate within the group of which they form part. Any viable resolution plan will have to keep up with the evolution of a business, so that, going forward, any significant initiative will need to include consideration of its impact on the RRP.

Question 24: The reference to “proportionality” is noted. This is fundamental. Clearly, access to an up to date BIP would assist an administrator. However, if in practice that BIP shows (for example) a complex web of international interdependent companies then, by definition, the administration will be complex and time consuming.

A fundamental policy issue therefore is the extent to which the authorities consider it acceptable for individual firms to be dependent on other entities over which the UK authorities may not have full supervisory powers. Obviously that is an inherent feature of global markets, but carries consequences in terms of complexity of resolution.

Question 25: I do not feel in a position to comment on this question.

Question 26: The same factors are likely to arise here as are discussed in relation to Question 23.

Question 27: This is likely to be driven by the state of the market at the relevant time. It will in practice be difficult to pin down in a failed firm and motivate able and marketable specialist personnel, although financial incentivisation may assist to some extent.

This is also an area where the rescue by a sale of part of the business may lead to the loss of valuable staff, making the resolution of the rest of the business more challenging. If possible and realistic, temporary "dual employment" arrangements could be considered.

Question 28: This will depend on the nature of the firm's business, but one would expect every area of activity, as well as key central functions, all to have some key staff. The condoc list should perhaps also include both Treasury and Risk functions. Issues may also arise where a firm uses outsourcing or offshoring.

Question 29: From a purely commercial perspective, the motivation for exercise of a termination right is likely to be either non payment of past services or the risk of non payment of future services. The threat of termination can be used by a supplier to ensure (some) payment for past services. If, because of the liquidity arrangements put in place in connection with the administration of a financial services firm, future supplier payments can be assured, there may in practice be little incentive for the supplier to terminate.

A question which may arise is whether suppliers will be entitled to be paid any arrears as a precondition of continuity of supply.

What becomes more complex is where, as a result of the insolvency, the services required are different from, or fall outside the scope of, the services contracted for, giving the services provider a new bargaining opportunity.

If, as a regulatory matter, the only basis on which a key supplier can provide services to a regulated firm is one on which the contractual power to terminate supply on insolvency of the firm is curtailed, then in practice suppliers who wish to work with regulated firms will have to live with that. Also, they will not be able to hold out for “ransom” payments.

There may be cases where the services provider is himself subject to some degree of regulatory supervision, giving the regulator a measure of influence over his conduct.

Question 30: I do not feel in a position to comment on this question.

Question 31: It may be a logical component of the creation of a BRO and (possibly) a cadre of staff working for that person that their contracts of employment should commit them to remaining in the employment of the insolvent firm and available to the Administrators for a minimum period post any administration. If complications arise because some key employees are transferred to a purchaser of the business or part of it, that purchaser is likely to be regulated and there may therefore be scope for influencing the purchaser to allow the administrators to share any key employees for a short period.

So far as competitiveness is concerned, there is a risk that energy devoted to managing for failure is not available to pursue new opportunities or, more generally, that the “managing for failure” ethos produces a less entrepreneurial or innovative culture, putting such firms at a competitive disadvantage to other international rivals.

Question 32: See my comments in relation to paragraphs 3.70 to 3.76 (page 9 above). Primary legislation would be required to exclude some of the fundamental rules which would otherwise apply to the distribution of what is an asset of the firm on a *pari passu* basis among all creditors and to preserve it from, for example, third party attachment.

Questions 33 and 34: Whatever the correct level of any operational reserve, it will have a number of consequences. First, it will increase the cost of doing business.

Secondly, it will create another category of preferred creditors. Consequently, it will subordinate other creditors. Thirdly, it may, to the extent it is used to “incentivise” key staff, be seen to be offering “rewards for failure”.

Decisions will have to be taken as to how the monies representing the operational reserve are held.

Question 35: This issue may need to be looked at in the light of appeals in the cases relating to Lehmans client assets and client monies cases. These will themselves provide a degree of clarity based on the current law and analysis of CASS rules, as well as the requirements of MIFID. It will then be for the government and the FSA to decide whether the clarity (and loss allocation) which emerges is consistent with the desired policy framework. Going forward, it will be helpful if the regulatory structure is clear without the need for judicial interpretation.

The starting point must be the need to ensure that sophisticated clients dealing with an investment firm understand the potential consequences of the particular contractual arrangements to which they sign up. This is recognised in paras 4.29-4.31 of the condoc.

There may be a tension between what is required to ensure ease and rapidity of handover in an insolvency (essentially simplicity of structures and clarity of entitlement) and the operational flexibility desired by those participating in the markets.

The issues which arise in relation to this question and question 36 apply not just to assets held by or in accounts in the name of the firm but also to assets held on behalf of the firm by, or in accounts in the names of, third party custodians.

Question 36: If currently warnings are not sufficiently clear, then the use of clearer and more comprehensive warnings is desirable. It may be that this applies not just at the level of the firm but also at the level of, for example, hedge funds, in terms of their making clear (or more explicit) to investors in funds managed by the hedge funds that the underlying assets may be at risk of prior claims (or premature disposal) by those providing leverage or liquidity to the funds.

It may also be that, in relation to assets held on trust, the trustees need to be reminded of the responsibilities they have with regard to the protection of assets.

A question which may be worth exploring (recognising that it will have cost implications) is whether there is any merit in encouraging segregation of certain different categories of client asset, so that, in particular, the assets of those clients who confer on the firm no right of use or hypothecation are maintained separately from the other pools of contractually less protected assets. Even if the "non hypothecation" assets are not individually segregated by client, the fact that there is a single "omnibus" ring fenced pool of assets with which the firm cannot deal (except on express client instructions) ought to make that pool of client assets easier to return in an insolvency.

It may be going too far to make client by client segregation a compulsory option for all firms. Perhaps some firms will offer it and set a price for the service, so that clients seeking this level of protection will gravitate to those firms. However, it could well be that, over time, clients conclude that they are not prepared to pay what it costs to obtain this enhanced protection. For sophisticated clients, the most important issue is for them to know what risks they are exposed to (and, where relevant, exposing their own clients/investors to).

Question 37: Having clear legal documents is desirable, although the more complex a transaction, the more scope there is for areas of uncertainty. The same applies to documents designed to be capable of applying in multiple varied situations. This is a fundamental point and probably one which cannot be legislated away. In addition to the points made in the condoc, there may be a number of additional factors to consider:

- Complications arising where agency relationships arise;
- The use of portmanteau and multi-partite "Master Agreements" which are by their nature both complex and purportedly all-encompassing;
- The use of multiple overlapping agreements which may not necessarily be consistent;
- The practice of using "confirms" relating to a particular transaction which may not immediately be followed up with a full contract and (as the condoc recognises) may be unspecific about key items such as the precise identity of the counterparty.

On occasion, there will be “battles of forms” between client and investment firm, each proposing its own standard, non negotiable and incompatible set of terms.

Arguably, the use of Master Agreements militates against clarity because by definition they are not adapted to the specifics of particular transactions. However market pressures mean that they are necessary. So the important thing is for those using these agreements to be familiar with their terms, if only so as to reflect on what may need to be adapted in any particular transaction.

Such familiarisation with these complex Master Agreements will inevitably take time for clients, so there may be a case for as much standardisation as possible.

There may also be merit in clients (especially those such as fund managers effectively holding for third parties) being encouraged from time to time to review the overall contractual relationships between themselves and the investment firms with which they deal.

The risk of contractual uncertainty or dispute may be a form of operational risk which calls for an element of capital buffer.

Question 38: It may be relatively easy to quantify the cost of drafting suitable wordings for warnings. It is more difficult to quantify the cost of achieving greater clarity in legal relationships overall.

There may also be a question as to where warnings should be placed. It may not achieve a lot to have it buried in a Master Agreement which is signed once at the outset of a relationship. It would have more force if repeated from time to time on transaction confirmations, for example.

Question 39: The principle of increased reporting requirements is sound. It is largely for the market to determine the frequency of such reporting and also the time period within which the details should be communicated. Inevitably there will need to be procedures for reconciling anomalies which arise.

Question 40: This may depend on what additional costs are entailed in maintaining both trade date and settlement date records, and whether those costs are proportionate to the benefit achieved.

Question 41: There is clearly merit, both in terms of a spur to internal good practice and as instilling confidence in clients, to having regular monitoring (including possibly spot checks). It is for discussion who should carry that out. There may be scope for this to be done by internal audit functions or by the CAA contemplated by chapter 5 of the condoc. Some degree of testing will presumably form part of formal external audit processes.

The question of communication of these review reports to clients could be a complex one, because the review will not necessarily have examined any particular client's portfolio and supply of the report will give rise to duty of care and liability issues, which may simply make the preparer of the report focus on risk mitigation rather than useful information.

Question 42: Clarification of the scope of FSA CF-29 is desirable.

It is less clear whether a single individual should have overall responsibility for CASS compliance, bearing in mind that effective compliance involves the interplay of a number of different legal, systems and operational activities. It may also be necessary to consider how this proposal interrelates to the proposal to have a single individual as BRO.

Question 43: I do not feel in a position to comment on this question.

Question 44: It is desirable that clients should be offered a range of options in terms of holding of client assets, particularly where custody and speed of dealing is the main service required. It is not clear what explicit government support is required, although a degree of adaptation of regulatory rules may be found necessary.

Evidently, creating and offering the structures described in paras 4.62-4.66 of the condoc will entail expense, some at least of which will be passed on to those wishing to avail themselves of the structures. Time will tell whether the cost differential is one which users in the market consider justifiable.

It will be more difficult to devise effective and simple enhanced protection structures to apply in circumstances where rehypothecation or right of use arrangements are required.

Question 45: Depositing client money with an affiliate may not be inherently risky. The bank holding the funds needs to have sufficient substance (perhaps evidenced by a rating). Client funds, wherever held, should be segregated from the firm's own funds and should not be subject to set off or combination of accounts. Undue concentrations of funds with a single entity should be avoided.

Also, client monies should not be used as a substitute for liquidity or working capital. There may be a case for imposing a more restricted regime, in terms of deposits with associates, on those groups operating their treasury functions without adequate regard to strict distinctions between legal entities.

Question 46: The present situation potentially creates a risk of a battle between competing equities. It is desirable to indicate clearly to the custodian what assets are proprietary to the firm and what assets are held for clients of the firm. Any rights of the custodian in relation to unpaid amounts owed by the investment firm should be limited to claims over proprietary assets.

There may be a subsidiary issue, namely the ability of the custodian to levy charges direct against the firm's client in respect of the period between commencement of the firm's insolvency and return of the assets.

Question 47: This is certainly worth investigating, to see if such a facility can be created in a cost effective manner. The question presupposes that one knows at the outset what is or is not a riskier activity. Market forces could lead to the riskiness of an activity being underestimated.

Question 48: It should be noted that in the Lehmans case, the court has now established a Bar Date for certain claims without the need for any new legislative power to have been conferred.

It seems unlikely that clients will deliberately delay taking action to provide information so as to recover their assets, so a legal duty (as opposed to a power) to set a Bar Date may be unnecessary. The main advantage of the power to set a Bar Date is the protection it provides administrators, and perhaps clients themselves, against valid but late claims.

Question 49: I do not feel in a position to comment on this question.

Question 50: No proposals can ever be guaranteed to be future proof. Whatever reforms are eventually implemented, it will be important to keep them under review in the light of market and structural developments.

Question 51: It may be necessary to consider the interaction of these proposals and the operation, and cost allocation arrangements, of the FSCS scheme.

Question 52: Provided the firm acting as Administrator is adequately resourced, I am not persuaded that a CAT will accelerate the process of returning assets to clients. It is not clear that assets would have been returned any more rapidly in the Lehmans case if there had been a CAT in place.

Question 53: As indicated on page 13, I was not totally sure I understood how the two methods would operate.

Question 54: Any CAT should be funded out of the insolvent estate, subject possibly to any directions to the contrary made by the court in a particular case. This is especially the case where client assets have been confused with the firm's own assets or used to provide liquidity.

Question 55: it is to be hoped that several of the other proposals would of themselves facilitate and accelerate the return of client assets, so that the additional introduction of a CAT might be disproportionate. In particular, if in any particular future case the same sorts of problems as to identification or allocation of client assets were to arise as have been highlighted by the Lehmans case, it is not clear that the existence of a CAT would enable them to be resolved any more rapidly.

Similarly, if problems arise as to the application of regulatory rules such as CASS, a CAT will have to seek court clarification in the same way as the Administrators in Lehman.

By contrast, a robust CAA function (whether or not part of a stand-alone agency) prior to failure of a firm might contribute significantly to facilitating return of client assets in any subsequent insolvency.

Question 56: There is a risk of increased costs arising out of a more formalistic approach being adopted by the CAT and the administrators, even if they are partners in the same firm. The appointment of the CAT from the proposed CAA could also create incremental costs.

Question 57: The Lehmans case has shown that, at times, it may emerge with hindsight that rules (and associated guidance) relating to client assets are less clear than might have been hoped. It might be quite delicate for an individual from the

CAA to mount the robust challenges required to resolve such issues. Further, it would be advisable for the CAT to have the knowledge and experience of a qualified insolvency Practitioner.

Question 58: It is clear that the regulation and supervision of client assets and client monies require greater resources than may have hitherto been the case, not least because of the complexity of operations of large international investment firms and of the transactions in which they engage. It makes sense to develop a focussed regulatory team with specialist expertise in this area and whose priority is to concentrate on issues relating to the protection of client assets and client monies. Precisely which structure is adopted to create this "centre of excellence" may be less important than the need to increase the resources dedicated to the task. The body or team identified will need to work closely with other domestic and international regulators (and policy makers) and to keep up with practical and operational developments in the markets.

Question 59: This question may raise the much wider question of the extent to which the FSA has oversight of the conduct of Insolvency Practitioners appointed over regulated firms.

Question 60: If a CAA is created, it would make sense for its remit to apply to all bodies holding client assets in a manner currently regulated by FSA. The degree of supervision required in any particular case will depend on the nature of each firm's business.

Question 61: Presumably the functions referred to in this question would be carried out by the CAA if established, so as to avoid duplication by FSA and CAA. The sense of the question seems to be that, because costs in this area will increase in any event (whether or not the CAA is established), the additional costs of creating a CAA may not be so significant. That may be broadly correct. Going forward, having both a FSA and CAA might lead to a degree of duplication and consequent incremental costs.

Question 62: If there is any merit in the view that implementation of some of the other proposals in the condoc may go some considerable way to achieving the overall objective, perhaps any legislation could be structured so as to confer powers to establish the CAA and CAT structures, but without immediately proceeding to create them.

Question 63: I do not feel in a position to comment on this question.

Question 64: Surely this is essentially an operational issue. Now that there has been a degree of publicity around the point, there may be scope for best practice guidance.

Question 65: Part 7 is a very important component of systemic protections. Partly because of the breadth of its application in terms of overriding the legal rules and principles which might otherwise apply in an insolvency, it has been drafted in a detailed fashion so as to circumscribe to some extent the scope of its application. However, it is essential that the scope is kept under review and adapted where necessary to reflect changes in market practices.

The focus should remain on systemic risks, not necessarily on protection of individual creditors, not least because it is possible for Part 7 to operate at the expense of a financial firm's general creditors outside the financial markets.

Questions 66 and 67: I am not in a position to comment on the AFME Protocol.

Question 68 and 69: I do not feel in a position to comment on these questions.

Question 70: Insolvency procedures are intended to be a collective process. There is a risk that initiatives such as that contemplated by this question, while in a sense justifiable from the point of view of the particular creditor concerned, lead to an overall fragmentation of the insolvency process.

Question 71: If the market is looking at stand alone spvs for holding client assets, it is possible that a similar solution might facilitate margin portability. Collective security trust structures, coupled with adhesion mechanisms, have been common in complex financings for a long while.

Question 72: I do not feel in a position to comment on this question.

Question 73: A facility, as opposed to an absolute requirement, may be the solution.

Question 74: A choice of accounts is desirable.

Question 75: There is nothing I would wish to add at this stage.

Question 76: Based on the summary in Box 6B, the EUI proposed approach would achieve certainty at an earlier stage that a transaction would never settle. No doubt further exploration might enable the proposal to be refined.

Question 77: I do not feel in a position to comment on this question.

Question 78: Action is required, although the degree of prescriptiveness, and the extent to which explicit Governmental involvement is needed, remain to be considered.

Question 79: It may not be necessary to introduce express legislation, although Regulators may want investment firms to be alert to the issues and to demonstrate what they are doing to address them.

Question 80: In many ways the precise form of the solution is best arrived at by the market, subject to the regulator making clear both that there is a requirement to achieve a solution and the nature of the minimum regulatory policy requirements.

Question 81: Like the establishment of a CAA (or a team within the FSA focussed on client asset protection), such a resource centre would be of use. Clearly it is essential to make sure that the expertise available remains up to date.

Question 82: Surely this is primarily an economic and risk issue. It is not obvious what Governmental action could alleviate the risk of a problem, without significantly interfering with the freedom of the markets.

Question 83: It is very difficult to answer a question like this in the abstract. Already the range of exposures of investment firms is very broad; that range may well be even more diverse in 5 or 10 years' time.

Question 84: It may be unhelpful to regard "unsecured creditors" as a single category, all of whom are affected in the same way. Some will be the usual sort of unsecured creditor to be found in any insolvency. Others will be suppliers whose position may be improved by the proposals in chapter 3. Others again may be clients who are unsecured creditors by default, because the mechanisms designed to protect client assets have, for whatever reason, proved inadequate.

An obvious factor in the insolvency of an investment firm is the delay in making any payment to creditors, so any proposals which speed up payments will be in the interests of all unsecured creditors.

As already indicated, a number of the proposals involve the creation of separate protections or regimes for particular creditors. This may be justified in policy terms, but goes against the nature of insolvency processes as collective procedures and may ultimately operate to the disadvantage of general creditors.

Questions 85 to 88: I do not feel able to make any useful comment on these points.

Question 89: I do not feel able to make a full assessment. The proposals ought to reduce issues, provided any new rules are clearly understood and are in fact complied with.

As already indicated, it might be hoped that not all the proposals are in fact required.

Peter Bloxham

February 2010

Consultation Document

Establishing resolution arrangements for investment banks

I set out below some thoughts on the above consultation. Where possible, I have referenced them directly to paragraph numbers, but in some cases the points are more generic.

Overarching issue

The UK can be a leader in proposing methods of orderly resolution, but co-operation and co-ordination with other jurisdictions will be essential. The international nature of investment banking will make it very difficult to achieve resolution without such multi-jurisdictional agreement.

Introduction

Some thought may be given to whether there is some sort of size-determined cut-off. The systemic implications of the collapse of a large investment bank are different from that of a small retail broker. **1.23** refers to "major firms" but it is unclear how this limitation will apply.

Enabling an orderly resolution

I agree with the proposed special administration objectives as listed in **2.16**. Where possible these should be conformed to the special objectives in the Banking Act 2009 to ensure consistency, in particular where a bank may have both deposit taking and investment bank activities. In **Box 2.A** the interaction is described as being with the BIP, but it would perhaps be more likely to interrelate to a BAP, where the PSP or bridge bank stabilisation options have been used. No doubt this will feature in the next consultation paper.

I agree that to achieve the special objectives there will need to be changes to the nature of the administrator's liability. Owing to the unusual position of the administrator, who is appointed to an unfamiliar entity at very short notice and obliged to start taking decisions immediately, I do not consider that a comparison to the position of directors, who may have been in office for extended periods and who should be familiar with the entity, is helpful. Where an administrator acts in good faith in pursuit of the special objectives (I have in mind particularly the return of client assets where that is later shown to be in error, resulting in loss to the estate if the assets cannot be retrieved) then he should have immunity from actions against him. It would assist in this to ensure that any actions relating to investment banks in resolution proceedings/special administration are heard in the Chancery Division of the High Court in London.

I do not believe that directors' liability should be materially amended. There is already a "good faith" defence within the Companies Act, and directors should be acting in accordance with the principle that *every step should be taken to minimise the loss to creditors*. However, where the directors are acting in accordance with instructions or guidance provided by the FSA after the FSA has been given the two weeks' notice contemplated by **2.53**, then they should have no liability.

The intra-day support proposal in **2.54 – 2.58** is subject to significant difficulties. It appears to us that settling or closing out open positions other than in the normal course of business may be a preference and may result in other creditors being placed in a worse position. In addition, the distressed entity is not likely to have funds available to settle these positions without granting security to the funder. The grant of this security may itself worsen the position of creditors generally, as the secured assets will then not be available to ordinary creditors.

There may well be situations where the provision of funding to settle positions pre-insolvency (for example certain illiquid credit default swaps) may be to the overall benefit of the estate, but we see this as an area of considerable difficulty.

I agree that co-ordinated communication is key. **2.60 et seq.** The suggestion of resource centres is constructive, but it will be necessary that the "resource centre" is capable of acting quickly and decisively. It is essential that its advice is independent and that important decisions are not delayed because the resource centre is concerned about its own liability. It must also not interfere with the administrator's independence.

"Opting in" for international entities, **2.68**, although theoretically very desirable, may in practice prove difficult to implement. It is not clear how an entity can opt out of areas of its home regulator's rules, or indeed the insolvency jurisdiction to which it is subject. It is difficult to conceive of a situation where, say, a US investment bank would be permitted by the SEC to opt in to the UK regime, either for regulation or for insolvency. I do, however, consider that a number of the suggestions made in the consultation paper, for example the use of bankruptcy remote client asset vehicles, could become "market standard" and therefore would be used although an "opting in" process may not be possible. I support the proposal that entities which are not subject to the UK regime should clearly disclose that fact in their literature.

Although I support the special objectives, it is important that any resolution regime should have as few other differences with existing insolvency legislation as possible, in particular regarding interaction with creditors and exit routes. The new rules will require conformation with the existing Banking Act 2009 and Insolvency Act 1986 (as amended). I believe that both of these Acts provide a stable and familiar environment which will help to provide certainty and efficiency to an Investment Bank resolution regime.

Requiring firms to manage for failure

The principle of a business resolution plan and associated officer is sensible. However, I suggest that the role of a BRO should terminate, except to the extent that a special administrator allows it to continue, on the appointment of the administrator. This will ensure there is no overlap or confusion. I agree that the BRO should be a board level appointment.

The resolution plan is an effective and helpful instrument for the administrator and will increase efficiency and reduce costs.

The principle that internal actions should be taken first is sensible. I see some difficulty with the proposed external actions in that taking these actions will inevitably result in market disruption and disruption to the entity. In both cases, directors must be very careful to avoid actions which will benefit one group of creditors over another. The role of centralised treasury functions (or entities) and cash sweeps are areas for particular caution.

Methods for retaining key staff need to be considered. I see difficulty in the proposed disincentives – there may be legal reasons why clawback of salary is not possible (unauthorised deductions from pay) and if the only reason for denying (for example) FSA authorised person status is that the employee refused to continue working for an insolvent company where he could accept employment with a solvent employer then it would appear to be open to challenge. Likewise, it may be difficult to enforce a restraint of trade term in these circumstances. Under the Banking Act 2009 the purchaser can be required to enter a Transitional Services Agreement where the use of key staff by the seller (the insolvent) can be agreed. I suggest that some modification to this could be further explored.

The definition of key staff will be an important aspect. Many key staff will not be bankers or authorised persons – for example, the IT staff will be extremely important. This is not confined to investment banks or financial institutions, and it appears to me that it will be difficult to explain why these people should be subject to special restrictions when employed by banks, but not where they are employed by, say, a large retailer.

I agree with the business areas suggested. Administrators would generally prefer to use the existing structures as far as possible.

The most efficient way to ensure continuance of key contracts and supplies is to extend s233 Insolvency Act to provide for communications and computer systems. I suggest that 90 days is not long enough, but an amendment to s233 would remove the time restrictions. This is a suggestion that has also been made by various parties in the recent consultation on company rescue.

I broadly support the idea of an operational reserve to be used until realisation proceeds are available. However, I do not think that it should be limited to items which fall within *only* 2.67 (a) and 2.67(f), but should be used for all r.2.67 expenses in their proper order of priority. This would provide consistency with existing legislation.

Reconciling and Returning Client Property

I agree with the principle that there should be greater clarity in the client contracts.

I see some difficulty with the suggestion that there should be limitations on transfers of client money/assets to jurisdictions or affiliates where there are issues around the interoperability with CASS. This may require careful scrutiny to ensure that there is consistency with, say, EU law.

Clear and effective support for clients

The special objective of prioritising the return of client money and assets is particularly important. The market-led concept of creating a bankruptcy remote client asset holding company is positive. Given these, I do not believe that a Client Asset Trustee is either necessary or desirable. I consider that having effectively a separate officer will increase costs without necessarily achieving efficiency. The CAT would seek access and information to the same key people as would the administrator, and there would need to be protocols and agreements covering access, information, staff time, premises, and other matters. In contrast, if the administrator's first objective is to deal with the client assets then he is in the position of being able to bring the whole resource of the administration and the estate to bear and he would have the same incentive to resolve the client issues as the CAT would.

I consider that the costs of dealing with client assets should probably fall on the clients. In principle, it seems unreasonable that they should fall on the general body of creditors. However, current practice is very confused. In order to apply costs to the client estate it is necessary to obtain a so-called *Berkeley Applegate* order. In cases where the client assets and monies are intact and reconciled, and the costs of dealing with them are consequently low, often the administrator considers it unnecessary to go to the expense of obtaining a *Berkeley Applegate* order. Clarity would be most welcome here, which should lead to greater consistency.

It is sensible that the FSA should sit on the creditors' committee. I suggest that consideration is given to the construction of a "Client committee" so that proper scrutiny of the process for dealing with client assets and monies can be maintained.

Managing complex creditor positions

I agree that there should be an ability to terminate open positions, and also that there should be a bar date for claims. The problem of ISDA non-defaulting counterparties refusing to terminate out-of-the-money (for them) contracts is a significant source of uncertainty. However, that is from our viewpoint as administrators. I recognise that a protection seller under a CDS may feel validly aggrieved at having to pay out when the reference asset (as opposed to the counterparty) has not defaulted and indeed may never eventually default.

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Investment Banking Resolution
HM Treasury
1 Horse Guards Road
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Attention: Alex White

1 March 2010

Dear Alex,

Response to the "Establishing resolution arrangements for investment banks" consultation

Terra Firma welcomes the opportunity to respond to HM Treasury's consultation on Resolution Arrangements for Investment Banks. Terra Firma is a leading European private equity firm whose investment vehicle, Camena Acquisitions Limited (Camena), holds assets in a segregated custody account with Lehman Brothers International (Europe) Limited (LBIE).

We are supportive of this consultation on Resolution Arrangements for Investment Banks and have responded, where appropriate, to the specific questions posed in the Consultation Paper. We have also identified a number of recommendations that should be considered in order to improve the implementation of the Resolution Arrangements.

We believe that fundamental reform is necessary. The changes need to be both simple and practical. We have drawn on our personal experience and that of Camena in the administration of LBIE when preparing our recommendations and comments. Our principal consideration has been to promote realistic ideas that will make a genuine difference.

We would be happy to provide any further information or detail as required. Please contact Chris Barnes at chris.barnes@terrafirma.com or on 020 7015 9693 or William Burnand at william.burnand@terrafirma.com or on 020 7015 9695.

Yours sincerely

CJBarnes

Chris Barnes
Head of Legal and Tax
Terra Firma Capital Partners Limited

RESPONSE TO THE TREASURY'S RESOLUTION ARRANGEMENTS FOR INVESTMENT BANKS CONSULTATION PAPER

DECEMBER 2009

EXECUTIVE SUMMARY

We make the following recommendations to improve the implementation of the Resolution Arrangements.

1. The term "investment firm" as used in the Consultation Paper should be clarified so as not to apply to private equity firms.

2. Based on Camena's experience of the LBIE administration, we feel that the key issues were a lack of transparency in the earlier stages as to what the administrator's plans were for a quick return of clients' assets, an apparent lack of information made available to the administrator by LBIE and its employees, a lack of coordination and cooperation between LBIE/its administrator and other parts of the LBIE group in administration, and no effective means of communication between clients and the administrator and/or LBIE employees. The policy initiatives outlined in the Consultation Paper are designed to improve the regime around the failure of investment firms, and to mitigate the issues referred to above and, to the extent they do so, Camena is supportive of them. However, in order for these proposals to have the impact which the Government intends, we believe that they should be enshrined in statute and/or in amendments to the FSA 's existing rules and/or in a firm's contractual arrangements.

3. Based on Camena's experience of the LBIE administration, our view is that the relevant bodies failed as part of their supervisory and regulatory role of an authorised firm to apply and enforce LBIE's legal obligations, with the result that this contributed materially to the administrator's inability to isolate and return clients' assets expeditiously. Our experience was that the inability of the administrator to return assets showed that the rules established to protect clients in exactly the situation which occurred with LBIE were not applied by LBIE, nor enforced by the regulatory authorities in a manner which ensured that the rules had their desired effect. Accordingly, we would recommend that there be regular and proactive reviews by the regulators of the policies adopted by firms to comply with the Government's proposals, and that any failure to adopt or maintain appropriate procedures should be the subject of appropriate sanctions, including fines.

4. The Consultation Paper highlights a number of cost-benefit analyses associated with the implementation of the proposals. While we are not in a position to say whether or not the Government's analysis is accurate, we would like to highlight, based on Camena's experience, the disproportionate level of fees charged to the LBIE estate and ultimately borne by LBIE's clients. It was a term of the arrangements proposed by the LBIE administrator that, before the administrator was prepared to distribute any assets, it would be entitled to recover costs from its clients of between 0.75% and 1% of the value of each client's claim in order to recompense it for the amount of time and effort spent investigating each client's claim. In the case of Camena, we feel that this considerable sum of money is disproportionate to Camena's straightforward claim to its assets. This sum is in addition to the fees that the administrator and its advisers have claimed from the LBIE estate in connection with this process for the

period September 2008 to September 2009 of \$238m (£154m) and \$112m (£68m) respectively. We feel that it is appropriate for the Government to include in its proposals steps to reduce as much as possible the costs associated with future administrations.

We would welcome the opportunity to discuss these recommendations further.

DETAILED RESPONSE

Chapter 1: Introduction

We note that the term "investment firm" as used in the Consultation Paper is based on the MiFID definition. Terra Firma is an investment firm on the basis of the MiFID definition. We would like to understand whether it is the Government's intention that its proposals as set out in the Consultation Paper are to apply to private equity firms. Our view is that these proposals should not apply to private equity firms, but only to those firms which are, in ordinary parlance, "investment banks".

Chapter 2: Enabling an Orderly Resolution

Terra Firma agrees that the adoption of Special Administration Objectives is essential to ensure that an administrator has a statutory obligation to, amongst other things, prioritise the return of client money and assets. Camena's experience is that the LBIE administrator did not devote sufficient time and resource to this area, with the result that 17-18 months have passed since LBIE's administration. Our view is that an administrator should focus at the outset on the return of those assets and monies which it, in consultation with the investment firm's clients, consider to be "easy wins". We agree that the introduction of a "bar date" would assist with the speeding up of claims, but this should be a statutory requirement rather than a matter which has to be approved by the court. In terms of supporting levers, we would suggest that an independent body be appointed to ensure that the administrator is complying with the SAO's. We would welcome the opportunity to discuss with you further the Consultation Paper's contention that the SAO's be based on the principle of "precedence".

One of the main reasons for a failure to return assets speedily in the LBIE administration in our view was the onerous, costly and unreasonable conditions imposed by the administrator on clients before they would agree to a return of assets. These conditions included an indemnity supported by a bank guarantee, cost cover and a requirement to return the assets to the administrator should the administrator so require. Camena's view at the time was that, given the straightforward nature of its claim, the cost of procuring a bank guarantee and the level of cost cover (c£75,000) was prohibitive. We appreciate that the administrator's requirements were driven by its desire to avoid and/or reduce its liability, but this is at odds with its primary obligation to affect an orderly and speedy return of assets. We therefore agree that a limited restriction on an administrator's liability is appropriate provided that the administrator is acting in pursuance of the SAOs. Liability should continue to attach to an administrator for breach of fiduciary duty, and there should be a carve out for fraud and negligence. We would have no objection to the suggestion that the personal liability of an administrator should not be greater than that of the investment firm's directors pre-insolvency. Our view is that an administrator is appointed to administer the assets of an insolvent company because they are, or at least should be, experienced and professional in doing so, and should not look to hide behind a court decision to support their decision. Based on our experience of the LBIE administration, the involvement of the court contributed to the delay in returning assets (in particular where the outcome of the court decision, despite legal advice, was uncertain). We would therefore suggest that the proposals to limit liability are sufficient without the additional protection of a court decision. If an administrator is in any doubt as to actions it should be taking, it should consult with their legal advisers and, to the extent adopted, the Client Asset Trustee.

We appreciate that it is a grey area for directors when having to consider the appropriate time to declare insolvency. Given the general principle that directors have to look increasingly to the interests of creditors the longer the period of possible insolvency continues, it is consistent with this that, as a practical matter, the directors should have a short period of time in which to close out the firm's positions and start unwinding the business before insolvency is declared.

Our experience of the first few days following the administration of LBIE was that there was a total lack of information available from the company (or those individuals with whom we had had day to day interaction) or from the administrator and that our calls and letters remained unanswered. All communication from the company and/or the administrator was effectively through the administrator's lawyers which we found to be a frustrating experience. We would therefore welcome greater communication between a firm and its clients at the outset of the administration. We would suggest that this could be done within 24-48 hours of the administration by way of a helpdesk in the UK (manned by employees of the firm or the administrator), an electronic portal through which questions could be asked and answers given and a series of face to face meetings with the relevant parties (which in Camena's case were repeatedly asked for). Ideally, the information available would include not only answers to general questions regarding the status of the administration, the responsible agency and contact details for that agency etc, but also to specific, client-related questions. The key to this is to give clients the strong impression that their concerns are being dealt with and that there is a sense of someone being in control with a handle on the asset position of the firm.

Chapter 3: Requiring Firms to Manage for Failure

As mentioned above, one of the most frustrating aspects of dealing with the LBIE administrator was the lack of available information from LBIE employees and a perceived lack of information flow between the administrator and LBIE. The appointment of a Business Resolution Officer at board level should go a long way towards ensuring that there is clear communication between a firm's board and the administrator. The proposed responsibilities delegated to the BRO as set out in the Consultation Paper seem appropriate.

We agree that the appointment of a BRO would have greater relevance if the BRO was a controlled function for the purposes of FSMA's Approved Person regime. The BRO should be a member of the firm's board and his or her responsibilities should be made part of the firm's corporate governance protocols and procedures, and engrained into the firm's culture by having the BRO report to the board on a regular basis. Whilst it should be incumbent on the BRO to update the FSA on the firm's resolution plans and any changes thereto, the FSA should also be encouraged proactively to manage a firm's BRO to ensure that the firm has implemented resolution procedures effectively.

For the reasons described above, the proposal for firms to prepare Business Information Packs is in our view a sensible one. In order to avoid the delays in an administrator being able to ascertain a firm's trading position and the assets and money held by it in trust, we feel it is important that firms prepare "living", real time documents which record these positions and which can be made available to an administrator within hours of a firm going into administration. Whilst the information described in boxes 3D-I is important, the BIPs clearly need to include (and be updated to include in the run up to the administration) specific details as to client assets which belong to the firm's clients and which are held on their behalf and client money that the firm holds or deposits with another firm for its clients. This should then go a long way to ensuring that there is as little delay as possible in an administrator being able to agree with clients which assets the firm holds and ensure a quick return of those assets without having to reconstruct from scratch what the firm's asset/cash position is.

As we believe was the case with the LBIE administration, the administrator removed the relevant LBIE team, preventing the prompt return of assets to LBIE clients, including Camena. We agree with the Government's suggestion to ensure that key staff (both at a managerial level and in the areas of counterparty claims, trust property and legal/tax) should be retained for a minimum period of 90 days to effect an orderly transition of the firm's infrastructure and operational knowledge to the administrator.

Chapter 4: Reconciling and Returning Client Property

We believe that it is critical to retaining the UK's position as an attractive financial centre that clients of a firm can be comfortable that their assets and money will be protected and returned both pre- and post-insolvency. Measures that are proposed to be adopted by the Government by statute to secure this aim are clearly important, including those proposed in the Consultation Paper: clarity in contractual arrangements, the use of warnings in contracts about the use of rehypothecation and client omnibus accounts, increased reporting and record keeping to increase transparency are all important practical measures to increase confidence in and visibility over a firm's operations as it effects those clients. The effect of this in our view will be to better inform the clients as to the risks that it might be taking on in entering into contracts with investment firms.

Based on our experience of the LBIE administration and the Government's professed desire to maintain stable financial markets in the UK, we are supportive of measures to improve the speed of return of clients' assets and money. It is now 17-18 months since the LBIE administration, and Camena is yet to have its assets returned to it. The measures proposed by the Government in the Consultation Paper, in particular those relating to limitations on the transfer of client money, a proposed change to custodians' right of lien over client assets and the establishment of a bar date are all sensible suggestions. Our experience of the LBIE administration is that the setting of a bar date by the administrator has not only accelerated the filing of claims by clients prior to such date but has also given the impression to the market that the bar date is a key date in the road to resolving clients' positions. This is particularly relevant to Camena where the administrator has indicated strongly that as soon as the claim is filed they will look to return its assets promptly. Based on the use of the bar date mechanism in the LBIE administration, we would suggest that the imposition of a bar date should be a legal requirement of the administrator.

Note

PAYMENTS COUNCIL

16 March 2010

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Our Reference

To Alex White
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From Antony Littleton

HMT CONSULTATION - ESTABLISHING RESOLUTION ARRANGEMENTS FOR INVESTMENT BANKS

The Payments Council is pleased to respond to the HMT consultation paper "Establishing resolution arrangements for investment banks". The Payments Council is the organisation that sets strategy for UK payments. It has been established to ensure that UK payment systems and services meet the needs of users, payment service providers and the wider economy. The Payments Council has three core objectives:
- to have a strategic vision for payments and lead the future development of co-operative payment services in the UK;
- to ensure payment systems are open, accountable and transparent;
- and to ensure the operational efficiency, effectiveness and integrity of payment services in the UK.
In this context, and in respect of its response to this consultation, the Payments Council is concerned with the smooth running and overall integrity of the UK's payments systems; and also the legal, regulatory and operational underpinning of risk mitigation measures for the settlement banks in EUI who provide the liquidity and credit that facilitates the daily settlement of securities in the UK.

1. SUMMARY

This Payments Council response concentrates on the aspects of the consultation dealing with:

1. Intra-day support (paragraphs 2.54-2.58). The Payments Council would be concerned if changes to legislation undermined the current protections afforded to its members who provide substantial amounts of liquidity and credit to their investment bank customers when settling open positions. It would be particularly

concerned if legislation were introduced that imposed obligations on a settlement bank to provide liquidity or credit post-insolvency without adequate protection;

2. OTC Cash-equity trades and the AFME protocol (paragraphs 6.26 – 6.39). Settlement banks in EUI welcome the increased certainty provided by initiatives like the LIBA (now AFME) Protocol for OTC cash equity trades;

3. Settlement issues (paragraphs 6.68 – 6.80). Similarly settlement banks welcome the resolution of issues such as those highlighted by the EUI situation with outstanding matched but unsettled trades;

4. Recovery and Resolution Plans (Chapters 2 and 3). The Payments Council welcomes a wide debate about the role of RRPs and is particularly interested in the authorities' views on where payments should fit in the plans of large complex firms that contain an investment bank and a payments bank. This must be achieved in a way that is consistent with the authorities' objective of maintaining the stable functioning of the payments systems, as expressed in the Banking Act 2009 and its accompanying Code of Practice, and does not affect the smooth running of the systems as a whole.

2. RESPONSES

The Payments Council is pleased to offer below more detailed comments on the points raised in the consultation paper that are relevant to the above.

1. Intraday support. Settlement banks in EUI provide liquidity and credit to support their customers' securities settlement activities by offering credit on an unsecured and/or secured basis. If secured, the collateral is the securities owned by the customer and held in CREST, subject to a floating charge. This practice is backed by a well-understood, if fortunately relatively untested, procedure under which EUI will, on disabling a failed participant and in response to the request of the settlement bank concerned, enable securities to be transferred into the bank's control. Central to this process is the exemption provided by Part 7 of the Companies Act 1989. Provided this process remains intact, and provided the collateral securities are capable of being valued and margined effectively (bearing in mind that market prices may be falling quickly), settlement banks should be prepared to go on providing liquidity and credit to a going-concern customer. But where the customer

is effectively in run-off settlement banks would seek to discuss with the authorities what sort of special arrangements would be appropriate. If legislation provided backing for special arrangements of this kind (and particularly post-insolvency) it would be important to understand how the rights and responsibilities of liquidity and credit providers would be affected.

2. OTC equity trades. As stated above settlement banks welcome the improved certainty that would result from initiatives such as the AFME protocol. Care must be taken, however, to ensure that dealing with outstanding unsettled trades of insolvent parties in this way does not create an extra exposure or liability for a settlement bank that is acting as sponsor for an insolvent customer. For example, an insolvent party may have taken delivery of stock which is now under the control of its sponsoring settlement bank and that stock is the subject of a matched but unsettled sale instruction in CREST. The valuation put on the securities by the non-defaulting party (as per the AFME Protocol) should not bind the sponsoring settlement bank to accept that value if it seeks to realise the securities taken as collateral.

3. Settlement issues. Settlement banks welcome the additional certainty provided by EUI's proposed change in relation to matched but unsettled trades.

4. Payments Council has a strong interest in the debate about Recovery and Resolution Plans in the context of its overall responsibilities to ensure the operational efficiency, effectiveness and integrity of payment services in general. It welcomes many of the proposals, particularly those in relation to the maintenance of an orderly business structure, information and general operational effectiveness within a failing firm. We have been concerned that one of the first areas to suffer impairment when a firm's management is under stress can be the record-keeping that is essential to making payments on behalf of customers. One reason why the payments systems held up well during the turmoil of the recent years is that records in the payments areas of banks were, or appeared to be, in better shape than it appears the records of customer securities balances were at LBIE.
   RRPs are linked to the concept of special administration, being a tool designed to make the administrator's job easier. Nevertheless there are many areas of these concepts that remain unclear. For example:
   - The consultation paper proposes a special administration regime with specific objectives aimed at an orderly wind-down of the firm's affairs. During this time it needs to be made clear that a third party (for example a lending banker providing liquidity to facilitate closing out open positions) is not

increasing its exposure to the failing firm without safeguards to enable it to recover outstanding debts.

- It is possible that an investment bank is a member of a group that includes a deposit taker and a member of a payment system. The payments system operators that are contracted to the Payments Council have discretion (and in certain circumstances are required) to suspend a member if, for example, they believe that that member threatens the integrity of their system. The authorities should be prepared to give guidance to payments system operators in these situations, especially if they wish to avoid a member's suspension.
- The paper envisages a period of several weeks where a firm which sees itself in difficulties puts in place certain internal procedures. Many of these procedures are, as the paper acknowledges, good practice which should be observed anyway. But to the extent that others involve identifying and possibly offering for sale parts of the business it may be difficult to prevent rumours springing up in the market. The clear concern is that this activity risks bringing about the very effect that it seeks to avoid. This is another example of the kind of circumstance in which payments system operators might wish to seek guidance from the authorities in respect of a potential threat to the integrity of their systems.
- There is a wider debate to be had on RRPs. If a firm which consists of both investment bank and deposit taking payments bank is required to make plans for the disposal of assets, including its business units, what is the strategic core which the firm aims to retain? In the Payments Council's view this should be the deposit taking payments units because this is likely to be the area of greatest public interest, and has the greatest impact on most of the Payments Council's members, but is possible that the bank's internal view puts greater emphasis on other areas of the bank. The Payments Council would welcome a dialogue with the authorities that led to greater certainty around these issues.

The Payments Council would be pleased to discuss any of these points with HMT and can be contacted as above.

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