HM TREASURY

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summary of consultation responses

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Introduction

1.1 The administration of Lehman Brothers International (Europe) has highlighted particular problems with the way that investment firms holding clients assets are handled on insolvency under normal administration procedures. Section 233 of the Banking Act 2009 gives the Treasury powers to introduce an investment bank special administration regime (SAR) and in September 2010 the consultation paper *Special administration regime for investment firms*[1] was published. This document summarises the responses received to that consultation, and sets out the Government's conclusions. The consultation document posed 13 questions in total, each of which is considered below.

1.2 Responses to the SAR consultation paper were requested by the 16 November 2010. In total, 12 responses to the consultation were received. Written responses – excluding those for which confidentiality was requested – can be found on the Treasury's website at the following address: www.hm-treasury.gov.uk/consult_investment_banks2.htm.

1.3 The Government is grateful to the number of organisations and individuals who took the time to respond to the consultation. The Government also thanks members of the Investment Banking Liaison Panel for their contributions in developing the SAR.

Scope

1. Do you agree with the Government's proposal to clarify the scope of the SAR through an amending order to make it clear that "client asset" includes client money? Will amending the order as described cover all the ways in which an investment firm can hold client assets? Would adapting the provisions of the SAR to apply in respect of limited liability partnerships (LLPS) or partnerships raise any significant consequences?

1.4 The Government had proposed two amendments to the definition of client assets as set out in section 232 of the Banking Act. The Banking Act defines client assets as "assets which an institution has undertaken to hold for a client (whether or not on trust and whether or not the undertaking has been complied with)".

1.5 The first proposed amendment was to make it clear that the term client assets also includes client money. Respondents agreed with this amendment and supported the Government's view that although the definition should be amended to include client money, insurance

[1] http://www.hm-treasury.gov.uk/d/consult_sar_160910.pdf

intermediaries which hold client money should not be within the scope of the SAR as they undertake different activities to investment firms.

1.6 The second proposed amendment was to add to the current definition of client assets the sentence, "assets which the client intended, when handing over the assets, to be able to exert a proprietary interest". Some respondents requested that the Government drop this proposed amendment as it would be hard to ascertain what a client's intentions were at the time the assets were handed over. The Government accepts this point.

1.7 Some respondents suggested that the definition should be more consistent with the FSA's client asset rules and should take into account any determination of the courts on this matter in the Lehman Brothers litigation[2]. Others questioned whether the "whether or not on trust" wording could be read as extending the definition with inadvertent and possibly unfortunate consequences.

1.8 The Government believes that it is important that the definition of client assets is sufficiently broad to ensure that all assets to which a client has a proprietary right are included. For example, if the definition only referred to assets held on trust, then assets held on bailment would be excluded, despite the client having a proprietary right to them. Although the Government appreciates the flexibility that a reference to the Client Assets Sourcebook rules could bring, it may be difficult to provide for this approach in regulations in a way that provides sufficient clarity over which firms are within scope of the SAR.

1.9 Some respondents also pointed out that the requirement to be holding client assets was a question of fact, separate from the nature of the firm or its regulatory permissions. This could create uncertainty for the market and investment firms themselves at the time of the insolvency, thereby delaying the implementation of the SAR, as it will not be clear whether a firm meets the criteria. The Government acknowledges this point, but takes the view that it is right that the SAR should only apply to firms which are actually holding client assets. In order to make a special administration order, the court would need to be satisfied that the institution was an 'investment bank' within the scope of section 232 of the Banking Act. Therefore, it would have to be satisfied that there were grounds for believing that the firm held client assets, just as it would need to be satisfied that the firm was unable to meet its debts as they fell due.

1.10 The Government will therefore use the order-making power in section 232 of the Banking Act 2009 to amend that section so that the definition of client assets includes client money. The order will also ensure that insurance intermediaries are not within scope.

1.11 No respondents raised any significant consequences which could result from adapting the provisions of the SAR to apply in respect to limited liability partnerships (LLPs) or partnerships. The Government will therefore adapt the provisions of the SAR to ensure that the provisions can apply also to LLPs and partnerships.

1.12 Finally, one respondent suggested that firms which do not pose a risk to the financial system should not be within the scope of the SAR. The Government takes the view that this would create too much uncertainty over the procedures that would apply in the event of a firm's insolvency. The SAR is sufficiently flexible to be suitable for use in respect of any investment firm coming within the definition of investment bank and it should, therefore, be the default insolvency option for all such firms.

[2] See the latest judgment of the Court of Appeal in Lehman Bros. Int. (Europe) (In Administration) c CRC Credit Funds Ltd & Ors. [2010] EWCA Civ 917.

Initiation of the SAR

2. Do you agree with the proposals for initiation of the SAR, as set out in draft regulations 4 to 8? These proposals:

- Provide for the appointment of an administrator by special administration order;
- Prescribe those who may apply to the court for a special administration order;
- Set out the grounds under which an application for a special administration order may be made;
- Set out the powers of the court when faced with an application for a special administration order; and
- Set out four conditions that must be fulfilled before an investment bank can be put into other insolvency proceedings.

1.13 The majority of respondents supported the proposals for initiation of the SAR. Entry into the SAR will be through the normal process of a court appointing an administrator. As the SAR is the default regime for all investment firms, application for the SAR could be made by anyone who would otherwise be able to apply for an administrator to be appointed by the court under Schedule B1, or to petition for a winding-up order under sections 124 or 124A of the Insolvency Act. However, some respondents questioned whether it was appropriate for universal banks to be subject to the SAR for their non deposit-taking activities until the appropriate stabilisation measures have been implemented under Part 1 of the Banking Act 2009.

1.14 The Government agrees that universal banks should not be subject to the SAR until the appropriate stabilisation tools have been implemented. Only after the use of stabilisation tools would a universal bank be placed into either the Bank Administration Procedure (BAP) or the new Special Administration (Bank Administration) Procedure. If it is placed into the Special Administration (Bank Administration) Procedure, then the objectives of the BAP take priority over the special administration objectives of the SAR, although it is expected that the administrators would start work on all the objectives. Note, however, that a universal bank, as a deposit taker, could be put into the Special Administration (Bank Insolvency) Procedure without any powers in Part 1 of the Banking Act being exercised.

1.15 The Government takes the view that the grounds for initiating the SAR - inability to pay debts or because it would be fair or expedient in the public interest to put the investment firm into special administration - are consistent with existing procedures.

Objective 1 – ensuring the return of client assets and money

3. Should the Government consider amending Objective 1 by applying it only to segregated client assets or by splitting it into two parts? Part (a) would be for the administrator to ensure the return of segregated client assets in priority to those not segregated, and part (b) would be to return all client assets, whether or not segregation has taken place.

1.16 The consultation document raised two options for amending Objective 1. Either it could be narrowed to cover only segregated assets, or it could be split into two parts. Part one would be for the administrator to return segregated client assets. Part 2 would be for the administrator to return all client assets regardless of whether proper segregation has occurred.

1.17 All respondents supported the objective to return all client assets and not to narrow it to only segregated client assets. However, views diverged on whether it should be divided into two parts.

Those in favour of splitting it argued that it is, as the law currently stands, easier for an administrator to return segregated client assets than it is to return non-segregated client assets, as:

- Segregated client assets will be more easily identifiable, being located in clearly defined accounts;
- Clients' proprietary claims in relation to such assets are more easily recognised in law (for example, there should be no need to resort to the remedy of tracing or to equitable arguments as to constructive trusts); and
- Segregated client assets do not raise the same sorts of custodian related difficulties as non-segregated client assets, since the custodian should not have any claims or liens over the segregated assets in respect of the "house" liabilities of the investment bank.

1.18 Concern was therefore expressed that, if the objective was not split, an administrator who focused initially on returning segregated client assets (because it is easier to do so) could face challenges from those whose assets were not segregated, with the latter potentially claiming that the administrator was not treating all claimants equally and that the administrator was failing to pursue the single objective. If, on the other hand, the administrator were to treat all claims in respect of client assets in the same manner, the administrator's decision to do so could be challenged by creditors with segregated assets, arguing that the administrator should prioritise the return of segregated client assets rather than cause "unnecessary" delays (and potential consequential losses) while investigating the claims of those with unsegregated assets.

1.19 Those against splitting the objective argued that, as the Regulations stand, the administrator would already be able to return unencumbered segregated assets before other assets, so splitting the objective would achieve little, aside from creating the impression that segregated client assets should be treated as a special priority over unsegregated assets. This could increase the prospect of challenge and delay. Some respondents also felt that the objective, as currently drafted, provides the administrator with suitable flexibility, and perhaps the drafting could simply make it more explicit that the administrator should be able to distribute assets as appropriate.

1.20 After considering the points raised, the Government has decided that, rather than splitting the objective to return client assets, a more appropriate option is to make it clear in the Regulations that the administrator is entitled to deal with and return client assets in whatever order the administrator thinks best achieves the objective. This will allow the administrator to return unencumbered segregated client assets without undue fear of challenge.

Bar dates

4. Do you agree with the bar dates proposal, as set out in draft regulation 11, which gives the administrator a power to set a bar date for the submission of claims over the client assets held by the investment firm?

1.21 The majority of respondents supported the proposal to allow the administrator to set a bar date (i.e. deadline) for submitting a claim to client assets. This was seen as an important part of the new regime and a useful option for the administrator, providing there are appropriate safeguards.

1.22 However, some argued that it was an unnecessary interference with a client's proprietary rights. This is because, if there is a late claimant who claims for assets which the administrator has distributed after the bar date, that client will only have an unsecured claim against the

estate because they are prevented from challenging the distribution as long as it was conducted in good faith. Concerns were also raised that this could undermine the UK as a safe regime for clients to hold their assets in custody.

1.23 The Government appreciates that use of bar dates implies the possibility that a late claimant could lose their proprietary rights to assets, and should therefore be subject to effective court oversight and procedural safeguards. However, the Government regards the bar date proposal as a valuable tool to:

- Ensure that administrators have the relevant information to return client assets promptly and accurately; and
- Give certainty to clients who receive back their assets that they will not be challenged by a third party for the return of those assets.

1.24 Under the Government's proposals, an administrator will not be able to make any distribution of client assets following the setting of a bar date unless court approval has been obtained. Some respondents stated a preference for court oversight at the point of setting the bar date rather than at the point of distribution, in order to reduce the scope for subsequent challenge and therefore keep the costs of the administration down, but the Government takes the view that oversight at the point of distribution would be more effective in ensuring that a fair and reasonable process has been followed, and in ensuring that late claimants have a realistic opportunity to challenge this.

1.25 The Government has also concluded that the following additional safeguards should be added:

- The owners of client assets (or the Financial Services Authority) have a right to seek an extension in the bar date in order to address any situation where clients may not, for good reason, be able to meet the bar date as set;
- The administrator should approach clients who appear from the records of the investment firm to have a claim to ask them to submit a claim; and
- The administrators should distribute assets to clients based on the records of the firm even if a client fails to submit a claim.

Note that these safeguards, along with the detailed process for setting the bar date, are to be included in the procedural rules.

Allocation of shortfalls

5. Do you agree with the allocation of shortfalls proposal, as set out in draft regulation 12, which prescribes how the administrator is to deal with a shortfall in the amount of client assets held by the investment bank in a client omnibus account?

1.26 The majority of respondents supported the proposal to allow administrators to allocate shortfalls in client asset omnibus accounts pro rata. The following amendments were suggested to improve the proposal:

- Where there are competing claims as between a primary client and persons claiming through it (or between rival claimants) there should be a power for the administrator to pay the money into an account acceptable to those parties or into court and that this would discharge his duties to make a distribution, leaving those parties to settle their entitlements at their own expense;

- Where a shortfall arises from an inadequacy of client assets in the relevant pool, then a third party with a security interest should be entitled to participate in the same unsecured claims as are available to the primary client;
- It should not have to be certain that there will be a shortfall for the rules to be operated. This is because whether there actually is a shortfall may itself depend on the outcome of separate disputes, which might result in additional assets being credited to the omnibus account and it would be wrong for the distribution of available assets to be delayed until all those disputes are resolved;
- The Financial Times should not be used to source prices for the purposes of determining fair market value. Most firms subject to these provisions will use one of the market price feed service providers whether they hold the assets themselves or if they have outsourced to a custodian then the latter will have access to price feeds. It would be better to require that the existing price sources be used to value assets or, if these are not available, to source them from another service provider; and
- The rules should include a prohibition on administrators acquiring assets to deliver as client assets in the event of a shortfall. This is to remove an incentive for an administrator to ensure there is no shortfall on those securities that have dropped in value since the start of the administration. This could occur if the administrator were able to go into the market to buy the securities at a price lower than that available at the start of administration, which would lead to the administrators gaining a profit for the good of general creditors. The administrator could realise the profit by (i) demanding full repayment of any outstanding loans from the client and/or (ii) enforcing the investment firm's security interest over the client's entire portfolio.

1.27 The Government has implemented most of the suggested changes to this proposal highlighted above, with the exception of the rule prohibiting administrators from acquiring assets post administration to deliver to clients. The Government is not persuaded that this should be actively prohibited when it may allow the administrator to realise better value overall for creditors.

1.28 Some opposed the proposal on the basis that the focus should be on ensuring that firms properly segregate client assets rather than attempt to devise a system for allocating shortfalls when they fail to do so. The Government recognises the importance of effective supervision and proper segregation, and notes that the FSA has strengthened its supervision of investment firms which hold client assets through the creation of a new client assets unit. However, that does not preclude the value of introducing a clear basis for allocating shortfalls where these arise.

Objective 2 – engaging with market infrastructure bodies and Authorities

6. Do you agree with Objective 2, as set out in draft regulation 13, that the administrator should work with the Authorities to minimise disruption to markets, and with market infrastructure bodies to facilitate the operation of default rules and arrangements and the settlement of trades?

1.29 All respondents supported this objective to ensure cooperation between the administrator, recognised bodies and the Authorities. Some respondents suggested the following amendments:

- There should be a right to refuse a request from an overseas market infrastructure body that would place the administrator in conflict with a request from the Authorities;
- The concept of default rules in Regulation 13(1)(a) should also include default arrangements. This is because systems, such as CREST, do not have default rules but instead have default arrangements;
- There should be a means for mediating the process of the administrators engaging with market infrastructure bodies and the Authorities or for the parties concerned being able to go to the courts to either compel compliance with a request under Regulation 13(2)(a) or require access under Regulation 13(2)(b); and
- There should be a specific requirement that the administrator will provide "timely" access for market infrastructure bodies and the Authorities to the facilities and premises of the investment firm.

1.30 The Government has implemented most of these amendments with the exception of inserting the word "timely", which the Government believes is implicit in the objective as framed.

Objective 3 – winding up or rescuing the firm

7. Do you agree with Objective 3, as set out in draft regulation 10, that the administrator should either rescue the firm or wind it up in the best interests of the creditors?

1.31 All respondents supported this objective, which requires the administrator to either rescue the firm or wind it up in the best interests of the creditors. Some respondents suggested amendments to ensure that the administrator can rescue certain business activities rather than the whole legal entity. However, the Government is satisfied that the existing wording, which is adapted from that of normal administration, is consistent with these aims.

The FSA's power of direction

8. Do you agree with giving the FSA a power of direction, as set out in draft regulations 16 to 20, to direct the administrator to prioritise one or more of the special administration objectives?

1.32 The majority of respondents supported the FSA having the power, after consultation with HM Treasury and the Bank of England, to direct the administrators to prioritise one or more of the special administration objectives over the others, in order to maintain the stability of the financial systems or public confidence in the stability of the financial markets.

1.33 However, concerns were raised by some respondents that the draft regulations did not dispense with the need for creditors' approval of the administrator's plan to comply with an FSA prioritisation order. Instead, consent to proceed in the face of the opposition of creditors to the FSA's direction would have to be obtained from the court, which would take time and the legal costs arising could be substantial.

1.34 The Government accepts that the creditor committee's approval should not be necessary in order to comply with a FSA direction, especially given that the administrator could otherwise go to court to have it overturned. The court approval process may limit the effectiveness of the FSA's direction and increase costs.

1.35 Some respondents also questioned whether the FSA's right to direct should be limited to an immediate crisis. The Government does not feel it is necessary or appropriate to limit the FSA's power of direction in this way. The FSA may only exercise the power where it is satisfied that this is necessary to maintain financial stability or public confidence and it has consulted the other Authorities. In practice this is likely to be in the immediate context of the failure, albeit not necessarily in the context of a crisis, but the FSA should be able to direct in any circumstances where such concerns over financial stability arise.

Continuity of supply

9. Do you agree that the continuity of service provisions, as set out in draft regulation 14, should be extended to require continuity of supply of IT and other key services?

1.36 All respondents supported the proposal that certain services essential to the running of the investment firm's business should not be capable of being terminated on insolvency as long as the administrator continues to meet payments. However, many respondents suggested additional essential services that should be included as part of this proposal, for example, the provision of computer hardware and the provision of secure data networks.

1.37 Some respondents raised concerns that the provision of commercial bank services was included as an essential service, as this could potentially catch on demand overdraft facilities and revolving loans. Respondents also made clear that market infrastructure bodies should not be included, so that they remain free to terminate supply of their services if necessary.

1.38 The Government has decided to add providers of hardware and data networks to the list of essential services. The Government also accepts that including the provision of commercial bank services may have unintended consequences and will therefore omit this from the list. It will also be made clear that suppliers who are market infrastructure bodies, such as Euroclear UK and Ireland (who operate CREST, the settlement system for UK securities), are not included.

Main modifications to Schedule B1 administration

10. Do you agree with the modifications to Schedule B1 administration, as set out in draft regulation 15? These modifications allow:

- Clients to vote alongside the creditors to approve the statement of proposals and sit on the creditors committee;
- The administrator to make a distribution to creditors without the approval of the court;
- Clients to bring an action against an administrator's conduct;
- The FSA to bring an action against the administrator complaining of harm to creditors, members and clients;
- The FSA to appoint a replacement administrator; and
- The administrator's remuneration and expenses incurred in pursuit of the return of client assets to be paid out of the client assets.

1.39 The majority of respondents agreed with the proposed modifications to the provisions of Schedule B1 administration as set out in the Insolvency Act 1986, but concerns were raised over the proposal that liquidator's costs in returning client assets would be chargeable to those assets. It was suggested that it might be better to charge those costs to public funds so they

could be scrutinised by Parliament, HM Treasury and the Public Accounts Select Committees. Alternatively, it was suggested that they could be borne by unsecured creditors.

1.40 The Government does not accept either of these proposals, but instead takes the view that it is fair that the costs of returning client assets are borne by clients. Public funds should not be used to pay expenses for returning client property in an administration, and requiring clients to bear the cost of returning of client assets is consistent with existing precedents.

SAR and the Bank Insolvency Procedure

11. Do you agree with the interaction of the SAR and the Bank Insolvency Procedure, as set out in Schedule 1 to the draft regulations, which allows the Authorities to decide whether the firm should be put into the Bank Insolvency Procedure or the Special Administration (Bank Insolvency) Procedure?

1.41 The majority of respondents supported the interaction between the SAR and the Bank Insolvency Procedure, although many of the respondents felt that more clarity was required over:

- Which UK authority would be in control of commencing a resolution process;
- What factors determined which insolvency procedure would be used; and
- Whether actions should be commenced pre or post insolvency of an investment bank failing.

1.42 The Government proposes to clarify the interaction between the SAR and the Banking Act provisions as follows. Where the investment bank is a deposit-taking bank with eligible depositors then, in addition to the insolvency procedures established under Parts 2 and 3 of the Banking Act, the Bank of England may apply to put the bank into:

- Special Administration (Bank Insolvency); or
- Where a property transfer power under Part 1 of the Banking Act 2009 has been exercised, Special Administration (Bank Administration).

The FSA may also make an application for Special Administration (Bank Insolvency) with the consent of the Bank of England.

1.43 However, where the investment bank is a deposit-taking bank but has no eligible depositors, the investment bank may be put into either:

- Special Administration (Bank Administration); or
- Special Administration.

SAR and the Bank Administration Procedure

12. Do you agree with the interaction of the SAR and the Bank Administration Procedure, as set out in Schedule 2 to the draft regulations, which allows the Authorities to decide whether the firm should be put into the Bank Administration Procedure or the Special Administration (Bank Administration) Procedure, where a partial property transfer is made by the Authorities to transfer part of the deposit business of an investment firm to a purchaser or a bridge bank?

1.44 The majority of respondents supported the interaction between the SAR and the Bank Administration Procedure although, again, many of the respondents felt that more clarity was required.

1.45 Following the use of one of the stabilisation tools under the Banking Act, a bank which also holds client assets may be placed into either the BAP or the new Special Administration (Bank Administration) Procedure. If the bank is placed in the Special Administration (Bank Administration) Procedure, then the objectives of the BAP take priority over the special administration objectives of the SAR, although it is expected that the administrators would start work on all the objectives.

Operational reserve

13. Do you agree that the Government should ring-fence the operational reserve in legislation so that it can only be used to pay certain suppliers of key services?

1.46 The majority of respondents supported the introduction of an operational reserve so that the administrators would have the funds available to pay for essential services. However, some felt unable to comment fully until the actual detail of this regulatory proposal had been consulted on by the FSA.

1.47 There was also general support for ring-fencing the operational reserve (if it is introduced by the FSA) in legislation so that it can only be used to pay certain expenses, and therefore provide assurance post-default, that costs and fees will be paid to key suppliers and staff to maintain continuity of service. However, it was considered important that the FSA should assess the costs of this proposal in the wider context of the new capital rules and prudential measures that are being introduced.

1.48 The Government agrees that the FSA will need to undertake a cost-benefit assessment in deciding whether to introduce an operational reserve, and will consider ring-fencing the operational reserve in legislation if the FSA brings forward a regulatory proposal.

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This document can be found in full on our website at:
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