Alternative Investment Management Association

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17 November 2010

Dear Sir / Madam

AIMA's response to HM Treasury's consultation paper 'Special administration regime for investment firms'

AIMA[1] welcomes the opportunity to respond to HM Treasury's consultation paper, 'Special administration regime for investment firms' ('the Paper').

As the proposals are intended to affect investment firms, of whom AIMA's members are clients (rather than AIMA members themselves), we will not respond to all questions posed in the Paper but instead we have set out below some general remarks on the proposals which are relevant to our members, in respect of their relationships with investment firms. Although AIMA is a body representing the hedge fund industry as a whole, with our membership including both the "buy" and "sell" side of investment banking transactions (i.e., investment managers and prime brokers), our comments here primarily reflect the views of "buy" side firms who, as part of their day-to-day business, place money with investment firms as part of the prime brokerage services provided to them.

General Observations

In general, we believe that the proposals laid out in the Paper could lead to improvements in the current level of protection for clients and could help towards ensuring the prompt and full return of client assets on the insolvency of an investment firm holding those clients' assets. The proposals seek to address many of the specific issues that became apparent during and after the collapse of Lehman Brothers, which has resulted in considerable losses and disruption for our members. However, we do not believe that the proposals will resolve all concerns and it remains to be seen if, in practice, they will provide greater protection to clients facing the insolvency of a large investment firm to whom they have given client.

We make the following specific comments on the proposals relevant to our members:

Special Administration objective

Objective 1 of an administrator's three Special Administration Objectives - duties when resolving a failed investment bank or investment firm under the proposals made - would be to "ensure the return of client assets as soon as reasonably practicable". As clients who will seek the safe and prompt return of assets and money, our members strongly support the intention behind the proposal. As it is important that client assets are returned in full, it is clearly essential that the proposals for a bar date and dealing with a shortfall in client assets are correctly and properly framed.

[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 1,200 corporate bodies in 45 countries, with around 31% of our manager members based in the UK and, of them, 207 are hedge fund management firms (another 59 are fund of funds managers).

Setting bar dates

The Paper proposes that administrators may set a bar date for the submission of claims by the beneficial ownership of the client assets or in relation to a security interest asserted over those assets, after which claims to client assets which are not submitted would be; paid out in full only if there are sufficient assets to cover what the claimant should have received; or if not, the claimant becomes an unsecured claimant against the estate for the value of the shortfall of their claim. As we stated in our response to HM Treasury's earlier consultation on 'Establishing effective resolution arrangements for investment banks', a bar date to a proprietary claim is in the nature of an interference with property rights and so is difficult to justify. Other proposals that would better help to identify client money may mean that there is less need for such a bar date and could avoid the issue of certain genuine claims becoming barred or failing to succeed in full simply because of missing set deadlines. We are aware that administrators are already able to set bar dates on claims if, on application to the court, that is deemed appropriate, so that it is unclear to us what the proposal adds in substance to the existing regime. Should the bar date proposal be taken forward, it will clearly be important that a generous amount of time is provided and that all avenues for identifying claims are used, to ensure that all claimants may submit claims.

Shortfall in client assets

The Paper proposes that a shortfall in securities of a particular description held as client assets in a client omnibus account should allow administrators to allocate the shortfall pro rata among clients. Shortfalls would, therefore, be apportioned among clients for whom the account holds assets, according to their respective beneficial interest in the securities.

We believe that this proposal raises the greatest number of issues and is likely to be unworkable. In short, issues arise because client assets which are agreed between the investment firm and the client to be segregated in client omnibus accounts are, in practice and in fact, not segregated but are held in the investment firm's own account (as occurred with Lehman Brothers). Although the FSA has recently approved proposals to reform its Client Assets Sourcebook (CASS) to include required reporting on client assets, a client is only able to monitor where its assets are held on the basis of what the investment firm has reported to it. The client has no independent means of verifying that the investment firm did, in fact, segregate assets in client accounts or indeed that they complied with their re-hypothecation cap as agreed between the parties. This, therefore, gives rise to an issue in that assets that were supposed to be held in a client account present two conflicted problems:

- A possible unprotected claim for that client;
- A shortfall in the client omnibus account.

The first of these two issues seems to have been resolved by the Court of Appeal in its August 2010 ruling in *Lehman Brothers International (Europe) (in Administration)*, although we understand that certain parties are currently seeking leave to appeal to the Supreme Court on this and other issues. That August judgment held that a statutory trust over the assets, which made it a client assets claim, took effect upon the receipt of those assets by the investment firm, rather than at the point at which they were segregated. Therefore, the client was still entitled to make a full client asset claim over the client asset pool regardless of whether, in practice, the assets were segregated in the client omnibus account. For this reason, there should be no shortfall in the client omnibus account, which would otherwise be pro rated among all clients with claims over the omnibus account's assets.

Section 2.23 of the Paper considers the option of narrowing the scope of Objective 1 (which is intended to expedite the return of client assets) by splitting it into two parts, so that the administrator (a) would ensure the return of segregated client assets in priority to those not segregated, and (b) would return all client assets, whether or not segregation has taken place. If assets are segregated by law, as client assets on receipt, regardless of whether, in practice, they have been segregated, then such a split option is not arguable.

Even if a higher court or new legislation were to overrule that position (against which we would argue), there remain many practical issues regarding pro rata payments, such as whether the administrator will rely on the

investment firm's required client asset reports in order to decide whether there has been a shortfall in the account. If they did rely on such reports, then an error in reporting would mean that a firm that had gone beyond the reports to monitor its assets would not be able to rely on the actual amount and legal status of its assets when calculating its claim. If it did not rely on the reports but looked beyond them to the actual amount and legal status, then those monitoring the positions through the reports would not be able to ensure the firm was protected.

A further point arises in respect of draft Regulation 12, concerning dealing with shortfalls in the amount of client assets held by the investment bank in a client omnibus account. The effect of 12(5) is, in essence, to credit the client's account with cash to the value of the shortfall as at the date when the investment firm went into administration - the shortfall claim. If the client had significant borrowings from the investment firm (which will be common if it is a prime broker), the inclusion of a shortfall claim reduces the outstanding amount of those borrowings. This may create a perverse incentive for an administrator to ensure there is no shortfall on those securities that have dropped in value since the start of the administration because if the administrator can go into the market to buy the securities at a price lower than that available at the start of administration, it could apply the profit for the good of general creditors. The administrator could realise the profit by (i) demanding full repayment of outstanding loans from the client and/or (ii) enforcing the investment firm's security interest over the client's entire portfolio. Accordingly, we recommend that the rules include a prohibition on administrators acquiring assets to deliver as client assets in the event of a shortfall.

Conclusion

We are pleased that HM Treasury has chosen to address many of the issues that became apparent during the financial crisis concerning how investment firms are resolved upon insolvency and especially that attention has been turned to how client assets can be protected during administration. However, we believe that the proposals, although generally positive, require further consideration in light of the *Lehman Brothers* Court of Appeal judgment and future changes to the FSA's CASS rules which we expect in the coming year.

We are pleased to have had the opportunity to contribute our views and we will be happy to provide further input as HM Treasury takes this process forward.

Yours faithfully,

Mary Richardson
Director of Regulatory & Tax Department

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SPECIAL ADMINISTRATION REGIME FOR INVESTMENT FIRMS

Comments by the Association of Business Recovery Professionals in response to the consultation document issued by HM Treasury in September 2010

Q1. 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 assets' includes client money? Will amending the order as described cover all the ways in which an investment firm can hold client assets?

1. Certainty is welcome and client money should in principle be treated the same as client assets. However where there are disputes about client money (for example segregation, identification etc) they should not hold up the return of client assets.

Would adapting the provisions of the SAR to apply in respect of LLPs or partnerships raise any significant consequences?

2. Special consideration needs to be given to how the proposed special administration regime would apply in the case of Scottish partnerships. Under Scots insolvency law these (but not limited liability partnerships) are dealt with under the sequestration regime; they are not treated as corporate entities as they are under the insolvency regime in England and Wales. Accordingly a completely new set of Rules would need to be put into place to facilitate this and it would be Holyrood rather than Westminster which would require to introduce them.

3. The legislation governing insolvent partnerships and limited partnerships in England & Wales is complicated: it is still possible for the affairs or an ordinary partnership to be wound up simply as part of bankruptcy orders being made against the individual members. The partnership insolvency legislation does not stand alone, but merely amends provisions of the Insolvency Act. As such it is difficult to navigate. Any proposal to adapt the provisions of SAR to ordinary or limited partnerships must therefore take into account the potential application of personal insolvency law to the partnership.

Q2. Do you agree with the proposals for initiation of the SAR, as set out above and in draft regulations 4 to 8?

4. Yes.

Q3. Should the scope of Objective 1 be amended in either of the ways set out in paragraph 2.23?

5. Broadly, the scope of Objective 1 should be as broad as possible so that there is no legislative impediment to the return of client assets where ownership is clear.

6. The principal issue is where the assets are held as collateral. One of the delays in returning assets relates to the potential liability of the administrator if he gives away collateral of the estate before he has established the full liability of the client (which may be quite complex). Where an investment firm goes into insolvency the normal balance is reversed – the client needs protection from the firm rather than the other way round. The administrator should be allowed to release collateral to the client in exchange for an undertaking to return it or cover any shortfall if necessary. If the undertaking is subsequently dishonoured the administrator should not be liable.

7. We note that in regulation 2 (Interpretation), 'return of client assets' means that 'the investment bank relinquishes full control over the assets for the benefit of the client…' We are not sure what is meant by 'full' in this context – it seems to us that the bank either relinquishes control or it does not.

Q4. Do you agree with the bar dates proposal as set out in draft regulation 11?

8. In principle, yes. However, we suggest that in regulation 11(3) the 'reasonable time' should be from the date of giving notice of the bar date, not the publication of the administration. This appears to be the intention indicated in paragraph 2.27 of the document. It might also be helpful to specify a minimum notice period.

Q5. Do you agree with the allocation of shortfalls proposal as set out in draft regulation 12?

9. Yes. In practice the calculation of the allocations will be difficult and complex but not impossible.

10. We have some difficulty in understanding the meaning and effect of regulation 12(3). We assume that it means that in the event of a shortfall, the secured party's rights are compromised to the same extent as the interest of the client – i.e. that the shortfall to the client will not give rise to a shortfall to the secured party which could result in claims against other assets.

Q6. Do you agree with Objective 2 as set out in draft regulation 13?

11. Yes – This is an extension of Part VII of the Companies Act, which works well.

12. We have some difficulty with the wording of regulation 13(3). There seems to be something circular about requiring the infrastructure body to provide the administrator with information to enable him to provide information to the infrastructure body. Perhaps the circularity could be resolved by removing the words 'in pursuit of Objective 2'.

Q7. Do you agree with Objective 3 as set out in draft regulation 10?

13. We agree with the objective, but have some reservations about the way the administrator's duties are expressed in regulation 10(2).

14. In regulation 10(2)(a), the words 'commence work on each objective' seem inapt. We suggest they should read 'commence work towards achieving each objective'.

15. Regulation 10(2)(a) says that the administrator must 'commence work on each objective … in order to achieve the best result overall for clients and creditors'. But the interests of the clients and the interests of the creditors may be in conflict; what is in the best interests of one may not be in the best interests of the other. We suggest that the words 'in order to achieve the best result overall for clients and creditors' are deleted.

16. Furthermore, it is simplistic to imagine that the administrator will work on each objective separately as a discrete area of activity at different times. It is inevitable that work will involve elements of working towards different objectives at the same time. For example, work towards Objective 1 is bound to involve engagement with market infrastructure bodies, and therefore overlap to an extent with Objective 2.

17. For this reason, we believe that the requirement in regulation 10(2)(b) to set out in the proposals the order in which the administrator intends to pursue the objectives is unnecessary and unhelpful. It is merely setting up a conflict which does not need to exist. The statement of proposals should simply be required to set out the manner in which the administrator proposes to achieve each or any of the objectives.

18. In the light of the foregoing, we believe that regulation 10(3) is unnecessary and should be deleted.

Q8. Do you agree with giving the FSA a power of direction as set out above and in draft regulations 16 to 20?

19. The suggested consultation with creditors is unwieldy. In practice these decisions will have to be made at great speed and the creditor process will drag it down. The court application subsequently is no great safeguard, as the decision by the court will come after the event. The thought that the court may decline to give the requested order even though the administrator may have already (quite properly) operated on the FSA's direction will be troublesome for the administrator. We therefore suggest that where the FSA directs the administrator to prioritise one or more special administration objectives creditor approval of the proposal is dispensed with.

20. We also suggest that there should be provision for the administrator to be able to apply to court to challenge the direction. In circumstances where that power is exercised, the administrator should be relieved of the obligation to report to creditors until the court has ruled on the application.

Q9. Do you agree that the continuity of service provisions should be extended as set out above and in draft regulation 14?

21. The services need to be on the same terms. Otherwise, yes, subject to the comments below.

22. We believe that the requirement to show 'hardship' in regulation 14(2)(a)(iii) is too light a test. There is a risk that it could prove too easy to show some degree of hardship in every case, which could render the entire provision useless. To avoid this danger, we suggest that the requirement should be for the supplier to show that the continued provision of the supply would cause 'unfair harm'.

23. In regulation 14(4) the second 'by' should presumably read 'for'.

24. The known deficiencies of section 233 of the Insolvency Act 1986 itself in respect of other services would of course continue to apply during the special administration regime.

Q10. Do you agree with the modifications to Schedule B1 administration as set out above and in draft regulation 15?

25. The justification of this in paragraph 2.49 is wholly unsatisfactory. The statement that it 'goes a long way' to helping him when he goes out on a limb to help clients is going to be of little use in practice. The result of this is that the administrator's lawyers will advise him that he will be taking a material personal risk. This will result in a visit to court, quite possibly a contested hearing or an unsatisfactory outcome from the court, as in the Lehman case. His liability has effectively been extended by the specific duty to clients. The clients will sue him for failing to hand over client assets; if he does so he is potentially on the hook for a loss to the estate if the estate suffers a loss to that client. Please see response to question 3 at paragraph 5 above, which may ameliorate part of this problem.

26. The paragraph 99 change is welcome, removing the need for expensive Berkeley Applegate applications, but the share-out of the costs amongst the client assets (and monies) will be complex. Furthermore, the majority of the costs will be incurred in identifying client assets before they are actually returned to the clients, and this will need to be recognised in the relevant drafting.

Q11. Do you agree with the interaction of the SAR and Bank Insolvency Procedure as set out above and in Schedule 1 to the draft regulations?

27. Yes.

Q12. Do you agree with the interaction of the SAR and the Bank Administration Procedure as set out above and in Schedule 2 to the draft regulations?

28. This process is excessively democratic. There will simply not be time at the start of the case to have this engagement with creditors. What is the administrator supposed to do in the meantime? If he waits for the creditors and the clients and

the court before he takes action there is the danger of a significant value loss. It will make the situation much more uncertain and unattractive to the private sector purchaser which will have a substantial negative effect on public funds.

Q13. 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?

29. We are not convinced of the need for this. A Bank of England overdraft on day one would solve the problem much more simply.

Association of Business Recovery Professionals
2 December 2010

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16 November 2010

Dear Mr Okubo,

HM Treasury Consultation paper dated 16 September 2010 'Special administration regime for investment banks'

We welcome the opportunity on behalf of the Association for Financial Markets in Europe (AFME)[1] to comment on the HM Treasury Consultation Paper on the 'Special administration regime for investment banks' (the "**Consultation Paper**").

General Remarks

We broadly support the detailed proposals and draft regulations relating to the special administration regime for investment banks ("**SAR**"). In particular we support the underlying direction of the proposals to provide a specific regime designed to provide greater clarity around the return of client assets and the promotion of an orderly winding up of the wide group of institutions that would fall within the scope of the SAR. We also support the approach of the SAR proposals in creating a "baseline" framework to accommodate the resolution process for the wide spectrum of investment banks: from small broker dealers to international financial institutions.

At the outset, we wish to express our hope that the HM Treasury acts now to expand the scope of the Banking Act 2009 ("**BA 2009"**) to include resolution powers for *all* investment firms where it is deemed necessary to protect the stability of, or to enhance confidence in, the financial systems. Such resolution powers may, for example, include 'bail-in' proposals, which could allow the authorities to restructure a failing financial bank so that it can be maintained as a going concern in appropriate circumstances, a concept developed in our September 2010 discussion paper.[2]

So, assuming the special administration regime for investment firms ("**SAR**") as proposed in the Consultation Paper would be the default for non-systemic firms, then we broadly support the detailed proposals and draft regulations relating to it. Determining non systemic firms, we would suggest, should be done along the basis of the financial stability objectives stated in the BA 2009 for the current stabilisation powers applicable to deposit holding institutions.

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[1] 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 visit the AFME website, www.afme.eu.

[2] "Prevention and Cure: Securing Financial Stability after the Crisis", for "Prevention and Cure: Securing Financial Stability after the Crisis" Resolution.

As for the proposed SAR, we do welcome the greater clarity around the return of client assets, including the setting of a bar date, and the promotion of an orderly winding up of the firm.

Clarifying when is SAR the appropriate resolution regime: overlap with the BA 2009

We note that the Consultation Paper recognises that SAR may not be the appropriate resolution regime for all investment banks that also hold deposits. We also note, however, that neither the Consultation Paper nor the draft regulations provide any clarity or guidance on how the relevant UK authorities are to identify the appropriate resolution regime and how the UK authorities would move from one process (such as the special resolution regime under the BA 2009) to a SAR regime.

Without a base level of clarity it is very difficult to fully comment on both the scope of the SAR proposals and their interaction with other resolution processes.

We would not, for example, support the use of SAR and the associated Special Administration Objectives ("**SAOs**") as the default resolution process for all non-depositing business of investment banks. Whilst the resolution of the failure of a significant majority of investment banks will be effectively supported by SAR and the SAOs, a number of institutions whose failure poses risks to market stability may well require a different process to address the specific issues relating to market stability and market contagion risks. We note that the proposed SAOs are focused on issues relating to the specific institution and its clients and creditors; SAR does not give the UK authorities the flexibility to address the wider market stability and associated contagion issues that a limited number of institutions carry with them.

To mitigate the risk of such a broad based framework catching institutions whose failure may result in systemic risks and whose potential failure should be addressed by more appropriate processes, it will be essential that a degree of clarity in identifying the appropriate resolution or protective measures is built into the SAR. The SAR must work with and support the wider industry initiatives currently being explored both within the UK and internationally.

We welcome the approach set out in the Consultation Paper and draft regulations that there should be a clear basis for identifying when the SAR applies and its inter-relationship with the existing provisions of the BA 2009. We are not, however, confident that the current proposals provide for the specific mechanics to identify whether the BA 2009 regime applies or the SAR and, more importantly, the transition from a BA 2009 process to a SAR.

We note that the current SAR proposals provide a regime to support a managed resolution process for investment banks; it does not (and arguably should not) focus on wider issues of stability to protect against systemic risk and wider issues of contagion.

We also note that the BA 2009 already enables the UK authorities to implement the special resolution regime which seeks to manage the impact of an investment bank failure on the wider market as well as protect deposit holders and its wider client base. We are concerned that the approach adopted in the Consultation Paper, the draft regulations and schedules may give rise to "boundary issues" in respect of which UK authority has control over identifying and selecting the resolution initiative in terms of the wider market issues. For further details on these concerns please see our response to question 11 below.

Finally, we note that the interaction between SAR and BA 2009 appears to fall within the remit of the activities of the Banking Liaison Panel and would strongly recommend that HMT work with the Banking Liaison Panel to identify and resolve any potential "boundary" issues between the various regimes.

Our full response to the questions is attached in the Annex to this letter. We look forward to continuing to work with you developing a stronger resolution regime for all investment firms.

If you have any questions please do not hesitate to contact me on 020 7743 9334.

Yours sincerely,

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ANNEX 1

Q1 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 assets" 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?

We support the clarification that client money forms part of client assets. We also support the inclusion of LLPs and partnerships in the SAR regime to the extent that such LLPs or partnerships hold client assets; a failed investment firm which holds client assets should not be subject to a different resolution regime simply as a result of its legal form.

We note that the FSA is currently consulting on CASS and suggest that, for the sake of consistency, the approach to client assets within the SAR process should be coordinated with the outcome of the current FSA consultation.

The suggested clarification states that "assets" will include:

- "client money"
- assets which the client intended, when handing over the assets, to be able to exert a proprietary interest.

We are concerned that the reference to "which the client *intended*, when handing over the assets, to be able to exert a proprietary interest" raises issues as to the nature of a client asset claim being based on a subjective intention rather than a clear and unambiguous proprietary claim. We therefore believe that greater clarity is required to prevent uncertainty and disputes as to a client's intention as to the treatment of assets.

We would suggest that, to avoid uncertainty, conflicting interpretations of the definition of client assets and potential disputes, the definition of client assets in the SAR must be consistent with the FSA Client Asset Rules and take into account any determination of the courts on this matter in the Lehman litigation. We would therefore strongly recommend that the SAR does not introduce a new and separate definition of client assets, but derives that definition by reference to the FSA CASS Handbook.

Q2 Do you agree with the proposals for initiation of the SAR, as set out above and in draft regulations 4 to 8?

We support the proposals for the initiation of the SAR.

We draw HMT's attention to our general remarks and response to questions 11 and 12 highlighting the current potential uncertainty of the implementation process between the SAR and BA 2009 Special Resolution Regime process. In certain cases the UK authorities will have the alternative option of placing an investment firm that whose failure would give rise to the risk of market stability issues or other systemic risk into the special resolution regime under the BA 2009. In these limited but important cases, we do not believe it would be appropriate for such institutions to be subject to SAR for their non deposit taking activities as contemplated by Schedules 1 and 2 to the Draft Regulations until the appropriate measures have been implemented under the BA 2009.

Q3 Should the scope of Objective 1 be amended in either of the ways as set out in paragraph 2.23?

We support the proposal that the focus of SAO 1 should be first on the return of segregated assets and then the return of all other client assets.

We also support the wider lack of express prioritisation of the SAOs as proposed in the consultation paper.

Q4 Do you agree with the bar dates proposal as set out in draft regulation 11?

We broadly support the proposal for a bar date however are concerned by the lack of court oversight in the current formulation of draft regulation 11.

We would strongly support a requirement for court oversight and approval of the bar date selected by an administrator to ensure that all client assets owners and creditors are afforded the protection of a court approved process.

Q5 Do you agree with the allocation of shortfalls proposal as set out in draft regulation 12?

We support the proposal that clarity is provided in the allocation of shortfalls. We also support the proposal that shortfalls in client assets are to be allocated by reference to client assets that are *securities of a particular description* held in *client omnibus accounts*.

We are not, however, entirely clear what assets are intended to fall within the second limb of the definition of "securities" which seeks to catch securities other than shares or stock and would welcome clarification on the current proposed definition:

> "Securities of a particular description" means securities issued by the same issuer which are of the same class of shares or stock; *or in the case of securities other than shares or stock, which are in the same currency and denomination and treated as forming part of the same issue*."

Is the intention of the second limb to catch debt securities such as bonds or is the intended scope of the definition wider with the aim to catch more exotic client assets such as derivative and money market products?

We also note that the European Union is currently consulting on the proposed Securities Law Directive and note that under the current proposals, the Securities Law Directive would have a direct impact on National Law in respect of the treatment of client assets and any arrangements implemented under SAR will need to be consistent with the requirements of the new Securities Law Directive.

We note that the allocation of shortfall mechanics set out in draft regulation 12 does not clarify the nature or timing of the shortfall; is the intention that draft regulation 12 is intended to exclusively address settlement errors or is the intention that all client account shortfalls will be addressed?

In terms of the timing of allocation of shortfalls, we note that there is a potential tension between the timing of the administration and the identification of client assets claims based on a disputed proprietary interest. Recent experience in respect of the administration of LBIE has shown that at the point of the administration order, not all client assets will be clearly ascertainable as post administration disputes are likely to arise in respect of proprietary versus contractual interests[3].

Draft regulation 12 (2) states:

> *"The administrator, in making the distribution, shall ensure that the shortfall be borne pro rata by all clients for whom the investment bank holds securities of that particular description in that same account in proportion to their beneficial interest in those securities.*"

Do the shortfall mechanics apply only to those client assets held in a client account at the point of administration and not to client assets that should have been within the relevant account but for a

[3] See e.g.: Re Lehman Brothers (3) [2009] EWHC 2545 (Ch)

breach of the custodian arrangements by the investment bank and could be recovered and re-allocated to the relevant account by the administrator? Similarly is the intention that disputed proprietary claims to assets that are or should have been held within the relevant account are excluded from the pro rata application of the shortfall?

We would welcome clarity in respect of the intended timing of the allocation of shortfall arrangements as contemplated by draft regulation 12.

Q6 Do you agree with Objective 2 as set out in draft regulation 13?

We support the current formulation of Objective 2. We note, however, that there will be a degree of overlap with the "living wills" arrangements currently being considered by HM Treasury and this overlap will need to be accommodated at a future date to ensure that the role of a business resolution officer and the detailed information contained in a business information plan are included to support the efficient interaction between an administrator and market infrastructure bodies.

Q7 Do you agree with Objective 3 as set out in draft regulation 10?

We support the current formulation of Objective 3 which is to either rescue the firm as a going concern, or wind it up in the best interests of the creditors.

Q8 Do you agree with giving the FSA a power of direction as set out above and in draft regulations 16 to 20?

We agree with the FSA having a power of direction as set out in draft regulations 16-20. We would, however, request that clarity is provided at the appropriate point in the future with regard to the specific roles of the FSA's successor bodies to exercise such powers of direction.

Q9 Do you agree that the continuity of service provisions should be extended as set out above and in draft regulation 14?

We broadly support the extension of continuity of service provisions as set out in draft regulation 14n for key service contracts. However, we have a number of concerns relating to the scope and potential effectiveness of the detailed proposals.

First, as recent experience with the failure of Lehman Brothers has shown, a significant number of these critical service contracts may not be contracts with the "investment bank" entity but rather will be with another entity within the investment bank's group. The relevant subsidiary is unlikely to fall within the definition of investment bank and therefore would fall outside SAR and the protective measures envisioned by draft regulation 14. Whilst draft regulation 14 applies to supply contracts with other group entities, as there is no ability for an administrator to "look through" the non-investment bank group entity to the ultimate supplier to hold the ultimate supplier to the underlying contractual arrangement.

Second, we are concerned that the draft regulation 14 (3) may have a number of unintended consequences including suppliers requiring short credit terms to allow the option of pre-administration termination of contracts for supply. If suppliers seek such arrangements in their supply contracts they may accelerate the decline of an investment bank by effecting an early termination of their contractual arrangements to protect their interests.

Third, we are concerned to ensure that the scope of draft regulation 14(5) does not inadvertently have a "chilling effect" on the provision of settlement and other services between banks. One clear example is the provision of services by CREST settlement banks. CREST settlement is provided on the assumption that the settlement facilities provided can be disabled at any time. If draft regulation 14(5) inadvertently changes this position it could result in CREST settlement being treated as a "supply" for

the purposes of draft regulation 14, it will have an effect on the way these services are supplied. We therefore believe that it is essential that greater clarity is provided in respect of the precise nature of "commercial bank services" to be included in draft regulation 14(5).

Q10 Do you agree with the modifications to Schedule B1 administration as set out above and in draft regulation 15?

We broadly support the modifications to Schedule B1.

We note that both the modifications to para 50 of Schedule B1 and the provisions of rule 61(1)(a) of the draft "Investment Bank special Administration (England and Wales) Rules 2011"(the "draft insolvency rules") do not expressly require the administrator to invite client asset owners to the initial meeting to consider the administrator's proposals:

- Schedule B1 Para 50: "(a) (a) In sub-paragraph (1), the administrator may, if they think it appropriate, also summon the clients referred to in paragraph 49(4) to the meeting of creditors and such clients shall be given the prescribed period of notice under sub-paragraph(1)(b)".

- Draft insolvency rules Rule 61 (1)(a): "As soon as reasonably practical after an invitation to the initial meeting has been sent out in accordance with paragraph 51(1), the administrator must have gazetted –

  (a) that an initial creditors' meeting, or as the case may be, an initial meeting of clients is to take place"

We assume that the intention is that, if there are client asset owners, the administrator must invite them to the initial meeting. It would be helpful to clarify this obligation in para 50 and draft rule 61(1) to ensure that the involvement of client asset owners in the SAR process is not at the discretion of the administrator. This clarification would ensure that Schedule B1 and the draft insolvency rules support the proposals on client voting set out in chapter 3 of the consultation paper.

Q11 Do you agree with the interaction of the SAR and the Bank Insolvency Procedure as set out above and in Schedule 1 to the draft regulations?

We broadly support the proposed interaction between the SAR and the Bank Insolvency Procedure. However, as highlighted in our general remarks, we believe that greater clarity is required around when the UK authorities would elect to utilise the mixed approach set out in Schedule 1 of the draft regulations.

We are particularly concerned that the current proposals for the interaction of SAR and the BA 2009 give rise to potential issues such as:

- which UK authority would be in control of commencing a resolution process;

- whether actions should be commenced pre or post insolvency of an investment bank; and

- in certain cases, an artificial demarcation of an investment firm's business for the purposes of identifying the appropriate resolution regime and UK authority providing oversight of such process.

In particular, whilst the current proposals focus on the replacement of the special resolution regime under the BA 2009 with SAR where a investment bank is a deposit taking institution, it does not deal with the initial inter-relationship and overlap issues between the BA 2009 regime and the appropriate application of a SAR process. As outlined above, this "patchwork" approach of adopting limited BA

2009 objectives with a default to SAOs for the non deposit elements of the failed institution may simply not be appropriate for achieving the appropriate resolution outcomes for certain investment banks.

We therefore strongly urge Her Majesty's Treasury to provide greater clarity around the relationship between the timing, implementation and scope of (i) the special resolution regime under the BA 2009 prior to the commencement of any "mixed" resolution process under schedules 1 or 2 of the draft regulations and (ii) the commencement of any "mixed" resolution process under schedules 1 or 2 of the draft regulations.

Q12 Do you agree with the interaction of the SAR and the Bank Administration Procedure as set out above and in Schedule 2 to the draft regulations?

We broadly support the proposed interaction between the SAR and the Bank Administration Procedure. However, as highlighted in our general remarks, we believe that greater clarity is required around when the UK authorities would elect to utilise the mixed approach set out in Schedule 2 of the draft regulations. In this respect we also reiterate our comments in respect of boundary issues set out in our response to question 11.

Q13 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 to key services?

We note that no further detail has been provided in respect of the nature and scope of an operation reserve since the Original Consultation Paper. We would draw your attention to the points raised in our response[4] to Question 16 of the original consultation paper[5] and again request that further detail must be provided to enable us to comment on the appropriateness of the nature and scope of any operational reserve.

We also wish to reiterate that, in clarifying the scope and quantum of the operational reserve requirement, HMT must have full regard to the provisions already required and/or contemplated by Basel III, the FSA Liquidity Asset Buffer and the EU Resolution Fund to ensure that there is no requirement for doubling up of reserves amounts.

[4] AFME response letter to Mr Alex White Esq dated 19 March 2010
[5] "Establishing resolution arrangements for investment banks" dated 16 December 2009

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HM Treasury Consultation on the Special Administration Regime for Investment Firms

Response of the City of London Law Society Financial Law Committee

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This response is submitted on behalf of the City of London Law Society ("CLLS") Financial Law Committee. Details about the CLLS, the Committee and its working party for this response appear at the end of this response.

Overall the Committee welcomes the introduction of this regime. There are, however, areas that require attention, particularly to ensure a smooth meshing with the expectations raised by the FSA's regime for client money in CASS and to address issues of legal uncertainty which would be likely to inhibit the regime achieving its intended benefits.

Our response addresses the questions raised in the Consultation:

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?

Yes, we agree with the principle that client assets should include client money. The changes with regard to covering LLPs and partnerships would be relatively a second order matter, but there will be policy considerations as to whether some bodies of this sort should be subject to this regime.

The question of concern is the way that the order is amended to describe client assets.

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

We are in agreement with the proposed approach.

3. Should the scope of Objective 1 be amended in either of the ways as set out in paragraph 2.23?

We consider that Objective 1 should be amended in the following ways:

To allow priority to be given to the return of segregated client assets;

To allow a series of partial returns as disputes are resolved, with an obligation to seek to return as much as is prudent on each occasion. This would be essential to prevent delay in distribution of assets which do not fully meet claims, pending the resolution of all disputes (both disputes as to which clients may claim on a pool and as to whether further assets should be included in a pool). We believe this is essential to achieve rapid distribution of the majority of segregated assets (eg where there is a shortfall in a client account holding assets of several clients in a pool) and also to enable non-segregated assets to be dealt with.

To ensure that the definition of client assets and the obligation to identify and return such assets works consistently with the approach in the FSA's CASS sourcebook as applicable from time to time.

4. Do you agree with the bar dates proposal as set out in draft regulation 11?

We believe the bar date proposals are essential to make these distributions feasible. In the context of sequential distributions, the choices are to have a single bar date at the time of the initial distribution or to have a series of bar dates, but with right to share only in distributions after a claim has been lodged. We believe that the ability to make sequential distributions is desirable and that the administrator should be allowed to retain a small proportion in reserve so as to be able to make adjustments on the final distribution to reflect the correct ultimate proportions.

It is also important to state the consequence of missing a bar date. We believe that proprietorial claims that miss a bar date should be provable as unsecured claims in the insolvency. The reference to the insolvency rules is not entirely clear.

However, if it turns out there is in fact no shortfall, claims that missed a bar date should be reinstated.

We also consider it would be more appropriate, if court approval is thought to be needed, for it to be given at the point when a bar date is set. Administrators deal with distributions to creditors without need for the distributions to be approved by the court and we do not think it is appropriate for the court to become concerned in approving the amount and timing of a distribution in the normal course. Such a court hearing would be very expensive if it were to examine the methodology and its application in detail.

5. Do you agree with the allocation of shortfalls proposal as set out in draft regulation 12?

We consider that the general principle in Regulation 12 is correct, but the detail of the Regulation requires considerable work to provide a fair and workable scheme.

First, we do not think these proposals are consistent with the netting approach to pay out indicated in paragraph 2.24 and Regulation 12 should be adapted to reflect this.

As a general principle, where a client has deposited assets which it holds on behalf of its own clients or over which it has granted rights to third parties (whether by way of charge, assignment or other transfer), the rights of the clients' clients or other third parties can be no greater than those of the client itself.

Where there are competing claims as between a primary client and persons claiming through it (or between rival derivative claimants) we suggest 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.

We have suggested language in Regulation 12 that addresses the above points.

Where a shortfall arises from an inadequacy of client assets in the relevant pool, then the third party should be entitled to participate in the same unsecured claims as are available to the primary client.

We do not think that as regards security interests Regulation 12(3) expresses the second concept entirely correctly. To the extent that a security claim cannot be satisfied out of assets in an omnibus account, it is likely that the security interest in its terms will also extend to any unsecured claim which the client has against the investment bank as a result of the shortfall in assets. The language of the section indicates that the security would fall away and the language should be adjusted to make clear that all that is intended is that the claim of the security holder against the assets in the omnibus account cannot exceed what the client would recover if there were no security in place.

In addition, we believe that Regulation 12 should apply where there may be a shortfall and that it need not 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 those disputes are resolved.

6. Do you agree with Objective 2 as set out in draft regulation 13?

We agree with this objective. However, the current definition of "market infrastructure body" in Regulation 2(1) is not sufficiently comprehensive. The investment bank will not always have a relationship to an investment exchange or securities settlement system through a market contract or a market charge but as a member or participant in the relevant body and the investment bank's duties may be set out in the "default rules" or "default arrangements" section of the body's rules. We have suggested a small amendment to the definition in Regulation 2(1) to address this.

Systems, such as CREST, do not have "default rules" under section 188 of the 1989 Act - as they do not enter into market contracts (see regulation 8 of the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001). However, such systems are likely to be "designated" under the SFRs and will have "default arrangements" within the meaning of regulation 2(1) of the SFRs - which are designed to limit systemic and other types of risk which arise in the event of a participant's default. We think it would be appropriate, and consistent with the policy objective behind regulations 10(1)(b) and 13, if the concept of "default rules" in regulation 13(5) included "default arrangements" within the meaning of regulation 2(1) of the SFRs. We have suggested amendments to Regulation 13 to address the position of systems such as CREST.

7. Do you agree with Objective 3 as set out in draft regulation 10?

Objective 3 is in effect the normal primary administration objective. We believe that the commencement of this process makes it highly unlikely that objective 3 (i) as set out in Regulation 10(1)(c)(i) can be achieved in the case of an investment bank and it would be important to acknowledge this in the objectives. We therefore think that this objective should be to rescue as much of the business of the investment bank as practicable in one or more going concerns. While this does not preclude rescuing the bank itself, it rightly places emphasis on rescue of business activity rather than a particular legal entity.

We also think that there needs to be consideration in Regulation 10 as to whether the objectives are ranked or equal. Objective 2 appears to be an on-going objective and at times objectives 1 and 3(i) could conflict. We think it should be specified that Objective 1 should be given priority, except where a business holding client assets is hived down into a company able to operate as a going concern within a short period (say 21 days) of the commencement of the administration or sold within a similar period to a third party going concern. This would give a balance between the interests of saving the business and returning assets.

8. Do you agree with giving the FSA a power of direction as set out above and in draft regulations 16 to 20?

We believe that the solution above would be more appropriate than a power of direction vested in the FSA. If a power were considered necessary, we believe that this would only be appropriate in the immediate crisis of the situation and should be limited to the sort of period mentioned above in which it would be identified whether a purchaser could be found or meanwhile parts of the business could continue as a going concern. We believe there would be greater general confidence in the operation of the insolvency process, if the power were as limited as possible.

9. Do you agree that the continuity of service provisions should be extended as set out above and in draft regulation 14?

We agree with the concept, but have concerns about aspects of Regulation 14.

These concerns centre on the supply of commercial bank services (but excluding the supply of services in respect of settlement facilities and the supply of uncommitted credit). We believe they need to be addressed to achieve legal certainty and avoid unnecessary disputes distracting attention early in the process.

There needs to be greater clarity as to what services commercial banks would be forced to provide in particular as to the definition of committed credit which, apparently would have to be supplied.

It is unclear whether it is intended that undrawn committed facilities should be available for drawing, but this is a possible inference from the language. We believe it would be better if new drawings were not covered by continuity provisions, but address below the issues that would arise if they were.

Committed credit includes the undrawn part of committed facilities, even though the terms of those facilities would undoubtedly prohibit drawing after the commencement of an administration. To

allow drawings by the administrator, it would necessary to provide for the disapplication of any relevant lending conditions.

Where facilities are revolving (either short term loans or overdraft) Regulation 14 would need to be clarified to identify whether these are to be available up to their committed (or drawn) amount even though they should be repaid and redrawn. Where repayment is inevitable (eg where the investment bank has directed payment by a third party of the amount due direct to the lender prior to the insolvency), it would need to be specified whether the amount received is available to be redrawn without conditions.

It would need to be clarified whether on demand overdraft facilities are to be treated as committed or not. We would not view these as committed in any sense.

If Regulation 14 provides for repaid funds to be readvanced and/or for committed funds to be advanced unconditionally, then consideration needs to be given as to whether their repayment should be treated as an expense of the administration which must be discharged before realisations are paid to floating charge holders or dividends are paid to unsecured creditors or before the end of the administration if that occurs without any distribution. It seems to us that this should be the case and this is not achieved by Regulation 14(4). However, it would probably be balanced to disapply the rule in Clayton's case (which would have the effect of converting the whole of an overdraft over time into money advanced during an administration), so that only any amount above the starting debit balance remaining outstanding at the conclusion of the administration (alternatively the amount above the minimum debit balance in the course of the administration) is treated as an expense of the administration.

In the event that Regulation 14 provides for repaid funds to be readvanced and/or for committed funds to be advanced unconditionally, Regulation 14(4) should be amended to clarify that interest and other proper bank charges associated with those advances fall within this section and should be paid on a current basis by the administrator (even though interest on funds advanced prior to the administration will not be paid).

Finally, it needs to be recognised that suppliers outside the jurisdiction may not be able to be forced to supply and that suppliers which are themselves insolvent will not be able to supply. It may be appropriate to relieve administrators of any obligation to spend funds seeking to obtain supplies in those circumstances. This is a point of general application, though it is likely to apply to some banking facilities of an investment bank.

10. Do you agree with the modifications to Schedule B1 administration as set out above and in draft regulation 15?

We believe that these changes are broadly correct.

11. Do you agree with the interaction of the SAR and the Bank Insolvency Procedure as set out above and in Schedule 1 to the draft regulations?

12. Do you agree with the interaction of the SAR and the Bank Administration Procedure as set out above and in Schedule 2 to the draft regulations?

With regard to questions 11 and 12 we think the approach taken is practical, even though it creates a complex set of potentially interacting powers and procedures.

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?

Whether the operational reserve is ring-fenced prior to administration is a regulatory matter. If it is ring-fenced, then it should be available to the administrator to assist in funding the administration, so the ring-fence should fall away at that point.

The City of London Law Society, the Financial Law Committee and its working party

The City of London Law Society 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 Financial Law Committee of the CLLS consists of practitioners in leading firms of solicitors practising in the City of London and advising banks, investment banks and other financial institutions and their clients on major financial transactions and financial structures, including consideration of the insolvency risks related to such transactions and structures, as well as on aspects of financial markets operations. Its working party in relation to the consideration of a special insolvency regime for investment banks consists of:

- Dorothy Livingston – Herbert Smith LLP (Chairman)
- David Ereira – Linklaters LLP
- Geoffrey Yeowart – HoganLovells International LLP
- James Curtis – Denton Wilde Sapte LLP
- Philip Hertz - Clifford Chance LLP

With review by the following members of the Insolvency Law Committee:

- Hamish Anderson - Norton Rose LLP (Chairman)
- Jennifer Marshall - Allen & Overy LLP
- Stephen Foster – HoganLovells International LLP

Interpretation

"market infrastructure body" means a recognised clearing house, recognised investment exchange, recognised overseas clearing house or recognised overseas investment exchange in relation to which the investment bank is a counterparty in a market contract or to a market charge or is a member or participant;

Special administration objectives

10.—(1) The administrator has three special administration objectives ("the special administration objectives")—

(a) Objective 1 is to ensure the return of client assets as soon as is reasonably practicable;
(b) Objective 2 is to ensure timely engagement with market infrastructure bodies and the Authorities pursuant to regulation 13; and
(c) Objective 3 is to either—
(i) rescue the investment bank as a going concern
Alternative (i) rescue as much of the business of the bank as practicable in one or more going concerns, or
(ii) wind it up in the best interest of the creditors.

(2) The order in which the special administration objectives are listed in this regulation is not significant: subject to regulation 16, the administrator must—
(a) commence work on each objective immediately after appointment, prioritising the order of work on each objective as the administrator thinks fit, in order to achieve the best result overall for clients and creditors; and
(b) set out in the statement of proposals made under paragraph 49 of Schedule B1 (as applied by regulation 15), the order in which the administrator intends to pursue the objectives once the statement has been approved.

Alternative: (2) the special administration objectives listed in this regulation should be addressed in the following way:

(a)During the period of [ ] days following his appointment the administrator should seek to identify parts of the business of the investment bank capable of operating as going concerns and to structure the business so that these activities are placed in separate legal entitities able to operate as going concerns or transferred for value to a third party going concern in pursuance of objecting 3(i);

(b)Thereafter priority should be given to objective 1 with regard to those client assets which have not been so transferred;

(c) Objective 2 shall be treated as a continuing objective throughout the administration, but shall not override the obligation of the administrator to achieve the best overall result for clients and creditors under objectives 1 and 2; and

(d) the administrator set out in the statement of proposals made under paragraph 49 of Schedule B1 (as applied by regulation 15), the way in which he intends to pursue the objectives [once the statement has been approved]. Note: it is not clear to us that this statement would be prepared or approved before the objectives were addressed.

(3) The administrator must work to achieve each objective, in accordance with the priority afforded to the objective as provided in paragraph (2), as quickly and efficiently as is reasonably practicable.

Objective 1 – distribution of client assets

11.—(1) If the administrator thinks it necessary in order to expedite the return of client assets, the administrator may [apply to the court for authority] set a bar date for the submission of—
(a) claims to the beneficial ownership, or other form of ownership, of the client assets; or
(b) claims of persons in relation to a security interest asserted over, or other entitlement to,
those assets.
Note: we do not consider that any application to the court by the administrator should be necessary, but if there were to be mandatory court involvement this would be the best point in the process.

(2) Claims under paragraph (1) include claims that are contingent or disputed.
(3) In setting a bar date, the administrator must allow a reasonable time after notice of the special administration has been published (in accordance with insolvency rules) for persons to be able to calculate and submit their claims.
(4) Where the administrator sets a bar date—
(a) the administrator shall make a distribution of client assets in accordance with the procedure set down by insolvency rules; Note: we assume that these will allow the holding of reserves in the case of dispute and payment to an agreed account or into court in a case where there is a dispute about entitlement. If not this should be dealt with in this Regulation.
(b) no distribution of client assets may be made after the bar date without the approval of the court. Note: we believe this requirement is unnecessary and this provision should be deleted. If it remains, the language should be clarified to make it clear that it applies to claims lodged at the bar date, not to the timing of the distribution.
(b) that distribution may be partial where the identified client assets are less than those claimed;
(c) further distributions may be made:. and
(d) any claims which cannot be fully satisfied by the return of client assets shall give rise to an unsecured claim in the insolvency of the investment bank to be valued as at the date of the commencement of the special administration. Note: As the bar date rules will affect claims for the return of client assets which fall outside Regulation 12 (eg because the assets are in a single designated account but some of them are missing), it is necessary to deal with the substitute claims if there are insufficient funds – these amendments leave some overlap which could be avoided with reorganisation of Regulations 11 and 12 so that common issues are dealt with only once.
(5) Where the administrator has made a distribution after setting a bar date, if the administrator then receives a late claim of a type described in paragraph (1) in respect of assets that have been distributed—
(a) there shall be no disruption to the distribution that has already taken place;
(b) the late-claiming claimant shall not be able to take any action to pursue those assets against the person to whom the assets have been returned or against any future recipient of those assets,
(c) the late-claiming claimant shall be entitled to share in distributions made after its claim has been made, but only to the same extent as if his claim had been made in a timely manner;
(d) the late-claiming claimant shall have an unsecured claim in the insolvency of the investment bank to be valued at the date of the commencement of the special administration.
Note: we believe that it might be helpful here to set out the rights of late claimants as they should not be deprived of their property rights with no substitution.
(6) The restrictions in paragraph (5) shall not apply where—
(a) the distribution was made by the administrator in bad faith in which the person to whom the assets were returned was complicit; or
(b) the person to whom the assets were returned is later found to have made a false claim to those assets.
(7) In this regulation, "bar date" means a date by which claims as described in paragraph (1) must be submitted.
(8) This regulation does not apply to client assets which should have been held by the investment bank in accordance with rules made under section 139 of FSMA (clients' money)).

Objective 1- shortfall in client assets held in omnibus account

12.—(1) This regulation applies if—
(a) the administrator concludes that there is a shortfall in the amount available for distribution of securities of a particular description held by the investment bank as client assets in a client omnibus account [or in an amount of money available for distribution in a client moneys account] which cannot be remedied following the resolution of on-going disputes; and
(b) the assets in question are not ones which should have been held by the investment bank in accordance with rules made under section 139 of FSMA (clients' money)..
(2) The administrator, in making distributions, shall ensure (subject to the treatment of late claims as described in regulation 11) that the shortfall in relation to securities has been borne pro rata by all clients for whom the investment bank holds securities of that particular description in that same account in proportion to their beneficial interest in those securities.
(3) Persons (including the investment bank) with a claim on the assets of a particular client shall be entitled to participate in distributions and shortfall claims in respect of the relevant assets in accordance with their entitlement as against that client (subject to the treatment of late claims as described in regulation 11), but at no time shall be entitled to claim in aggregate in excess of the distribution which the client would have been entitled to if there had been no claim by any such person. In particular, where a client's beneficial interest in securities held in the account is subject to a security interest of a third party or the investment bank, any reduction of the client's beneficial interest as a result of the application of paragraph (2) shall limit correspondingly the right of the security holder in respect of the distribution, but shall not affect the rights of the security holder in respect of the client's shortfall claim as described in paragraph (4). [Where there is a dispute as between two or more such persons and/or one or more such persons and the client as to their respective share of a distribution, the administrator may make the distribution as agreed by all or them [or lodge the assets in court] so as to discharge his obligations in relation to that distribution as regards all such persons and the client, leaving the dispute to be resolved between them]; Note: this may be more appropriate as an insolvency rule.
(4) The shortfall borne by a client under paragraph (2) [or in relation to a client money account] is that client's shortfall claim against the investment bank ("shortfall claim") which shall rank as an unsecured claim.
(5) The value of a client's shortfall claim in relation to securities shall be based on the market price for those securities to which the shortfall claim relates on the date the investment bank entered special administration or, if that is not a business day, on the last business day prior to the investment bank entering administration.
(6) In this regulation—
"business day" has the meaning set out in section 251 of the Insolvency Act;
"client omnibus account" means an account held by another institution in the name of the investment bank, made up of multiple accounts of clients of the investment bank;
"market price" means—
(a) the middle price of the security on the day in question published by the Financial Times or an equivalent pricing source; or, if this is not possible to ascertain,
(b) a fair market value for the security as determined by the administrator based on—
(i) historic trading prices for comparable securities for the day in question as published by the Financial Times or an equivalent pricing source,
(ii) market data in respect of the relevant market on which the security is traded, or
(iii) the result of the operation of any models or pricing methodologies performed by the investment bank or a third party; and
"securities of a particular description" means securities issued by the same issuer which are of the same class of shares or stock; or in the case of securities other than shares or stock, which are of the same currency and denomination and treated as forming part of the same issue.

Objective 2 – engaging with market infrastructure bodies and the Authorities

13.—(1) The administrator shall work with—

(a) a market infrastructure body to—
(i) facilitate the operation of that body's default rules or default arrangements,
(ii) resolve issues arising from the operation of those default rules, and
(iii) facilitate the settlement or prompt cancellation of non-settled market contracts; and
(b) the Authorities to facilitate any actions the Authorities propose to take to minimise the disruption of businesses and the markets as a consequence of a special administration order being made in respect of the investment bank.
(2) In paragraph (1), "work with" means—
(a) comply, as soon as reasonably practicable, with a written request from such a body or from the Authorities for the provision of information or the production of documents (in hard copy or in electronic format) relating to the investment bank;
(b) allow that body or the Authorities, on reasonable request, access to the facilities, staff and premises of the investment bank for the purposes set out in paragraph (1),
but no action need to be taken in accordance with this paragraph to the extent that, in the opinion of the administrator, such action would lead to a material reduction in the value of the property of the investment bank.
(3) Where a market infrastructure body has made a request of the type referred to in paragraph (2), that body shall provide the administrator with such information as the administrator may reasonably require in pursuit of Objective 2.
(4) Under this regulation a person shall not be required to provide any information—
(a) which they would be entitled to refuse to provide on grounds of legal professional privilege in proceedings in the High Court or on grounds of confidentiality between client and professional legal advisor in the Court of Session; or
(b) if such provision by the body holding it would be prohibited by or under any enactment.
(5) In this regulation—
"default rules" has the meaning set out in section 188 of the Companies Act 1989(**a**);
"default arrangements" has the meaning set out in regulation 2(1) of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999; and
"enactment" includes—
(a) an enactment comprised in or in an instrument made under an Act of the Scottish Parliament;
(b) Acts and Measures of the National Assembly for Wales and subordinate legislation;
(c) Northern Ireland legislation,
and any regulation, directive or decision of the European Union.

Continuity of supply

14.—(1) This regulation applies where, before the commencement of special administration, the investment bank had entered into arrangements with a supplier for the provision of a supply to the investment bank.
(2) After the commencement of special administration, the supplier—
(a) shall not terminate a supply unless—
(i) any charges in respect of the supply, being charges for a supply given after the commencement of special administration remain unpaid for more than 28 days,
(ii) the administrator consents to the termination, or
(iii) the supplier has the permission of the court, which may be given if the supplier can show that the continued provision of the supply shall cause the supplier to suffer hardship; and
(b) shall not make it a condition of a supply, or do anything which has the effect of making it a condition of the giving of a supply, that any outstanding charges in respect of the supply, being charges for a supply given before the commencement of special administration, are paid.
(3) Where, before the commencement of special administration, a contractual right to terminate a supply has arisen but has not been exercised, then, for the purposes of this regulation, the

commencement of special administration shall cause that right to lapse and the supply shall only be terminated if a ground in paragraph (2)(a) applies.
(4) Any expenses incurred by the investment bank by the provision of a supply after the commencement of special administration in accordance with this regulation are to be treated as necessary disbursements in the course of the administration.
(5) In this regulation—
"commencement of special administration" means the making of the special administration order;
"supplier" means the person controlling the provision of a supply to the investment bank under a licence, sub-licence or other arrangement, and includes a company that is a group undertaking (within the meaning of section 1161(5) of the Companies Act 2006) in respect of the investment bank; and
"supply" means a supply of—
(a) computer software used by the investment bank in connection with—
(i) the reception, and transmission of orders in relation to securities, or
(ii) the trading of securities;
(b) financial data;
(c) broadband and electronic mail;
(d) data processing;
(e) commercial bank services (but excluding the supply of services in respect of settlement facilities and the supply of uncommitted credit).

Note: add additional provision to address issues on meaning of commercial bank services raised in CLLS response to question 9 and consider adding provision to address administrator's duties in relation to suppliers which are outside the jurisdiction or themselves insolvent.

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16 November 2010

Submitted by email

Dear Mr Okubo

Consultation response: Special administration regime for investment firms

We refer to HM Treasury's paper "*Special administration regime for investment firms*" and are pleased to provide you with our comments on the issues raised.

On a general point, we reiterate our view that we do not consider a bespoke administration regime for investment firms is necessary and remain unconvinced that a separate process will meet the objectives of returning client assets any quicker than the present framework facilitates. Subject to that general reservation about the introduction of a special administration regime, we have the following comments to make in relation to the specific questions raised in the consultation.

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?**

   We agree that clarification of the scope of the SAR and, in particular, widening the definition of "client assets" pursuant to an order under Section 232 of the Banking Act 2009" to include client money, is important. Although we query whether a further interpretation of "client" then is necessary in Regulation 2 as it repeats part of the definition of "client assets" already contained in section 232 of the Banking Act 2009.

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

The proposals for initiation and draft regulations 4 to 8 of the SAR regime seem appropriate.

3. **Should the scope of Objective 1 be amended in either of the ways as set out in paragraph 2.23?**

One of the key objectives of the SAR is the expedited return of client assets. Objective 1 as drafted and, in particular, the imposition of a bar date, could be construed as delaying the process for cases where the client assets have been segregated and can easily be identified. We therefore think that there is some merit in splitting the objective into two parts, so that for segregated client assets there is no delay in their return. The FSA's Policy Statement 10/16, which sets out impending changes to the Client Assets Source Book and gives greater transparency as to how client assets are held, may in any event make this less of an issue, especially in relation to prime brokerage arrangements. In any event, there would be some merit in clarifying that Regulation 11 can apply to all or just part of the client assets held by the firm.

4. **Do you agree with the bar dates proposal as set out in draft regulation 11?**

We reiterate our concerns raised in the context of the earlier consultation "*Establishing resolution arrangements for investment banks*" where we raised our concerns regarding the imposition of a bar date after which property rights are extinguished. We remain of the view that the principle of establishing a bar date is a radical solution. It essentially means that assets held with a trustee or bailee will in some circumstances not be ring-fenced in the insolvency of that entity. This means there is less certainty of the safety of client assets held with an entity which is or may be subject to English law insolvency proceedings. This could potentially affect not only entities providing custody services but also fund depositaries and bond trustees, if authorised to provide safeguarding and administering for the purposes of FSMA. Given the additional liabilities to be imposed on depositaries delegating the holding of fund assets, and the existing requirements for due care in selection of delegates for MiFID regulated custodians, this uncertainty could deter use of delegates in the UK and could therefore be detrimental to the business of anyone currently holding client assets in the UK. It is an odd result that measures designed to give additional protection in insolvency in fact create more legal uncertainty (under the present law, the analysis of the ring-fencing of client assets in the insolvency of a custodian is not straightforward, and this change in the law would make the situation less clear). In addition to these reservations, we also consider that the approach set out in Regulation

11 imposes a significant responsibility on the administrator. Whilst we recognize that the flexibility for the administrator to impose a bar date may have certain practical advantages, given the consequences of missing the deadline, we think that the administrator's decision could give rise to frequent challenge and cause additional delay. Notwithstanding our reservations, if this radical solution is to be implemented, we think that it should be done under the auspices of the court and not delegated to the administrator. In light of the significance of imposing a bar date and, in particular, the loss of a client's proprietary claim should the bar date be missed, seeking court approval would be a necessary and important safeguard. Although we recognize that this may attract further costs and possibly take longer, we think that it is an essential safeguard and will ultimately make the process of return of client assets more efficient and less likely to be challenged.

5. **Do you agree with the allocation of shortfalls proposals as set out in draft regulation 12?**

The allocation of shortfall pro rata for particular securities seems appropriate, however further clarity would be welcomed on what is meant by 'market price' for the purpose of calculating any shortfall.

6. **Do you agree with Objective 2 as set out in draft regulation13?**

We query whether Objective 2 is necessary. We do not think that the issues that arose in the context of LBIE arose out of a lack of willingness to cooperate, which seems to be all that Objective 2 achieves as presently drafted.

7. **Do you agree with Objective 3 as set out in draft regulation10?**

We agree with the principle of Objective 3, but think that it should either follow more closely the wording of Schedule B1 so that (c)(ii) reads "achieve a better realization for creditors as a whole than if the company were wound up", or alternatively, adopt the same wording as appears in section 40 of the Banking Act 2009. In so doing, this would give the administrator the ability to trade for a short time rather than just liquidate the assets. The provisions of Schedule B1 can be applied to allow the SAR to be wound up or dissolved directly.

8. **Do you agree with giving the FSA a power of direction as set out above and in draft regulations 16 to 20?**

We think that the prioritization of the objectives should be addressed by the court, with the assistance of the FSA, when the administrator is appointed. If the priorities change then the consultation process described in the regulations may be useful.

9. **Do you agree that the continuity of service provisions should be extended as set out above and in draft regulation 14?**

We appreciate that a provision for the continuity of services may be useful but question whether the defined list of supplies is adequate. It does not contain any reference to hardware e.g. terminals/pc screens and telephones, which may be equally as crucial and may not necessarily be owned out right by the firm. We query whether deciding who is a key supplier should be left to the discretion of the administrator rather than having a prescribed list which may become out of date. We are also unclear as to how this ties in with the operational reserve referred to in question 13.

10. **Do you agree with the modifications to Schedule B1 administration as set out above and in draft regulation 15?**

We agree with the proposed modifications to Schedule B1 of the Insolvency Act 1986, although we have a number of drafting queries.

Paragraph 47 - reference is made to the statement of affairs and inclusion of client assets. In the proposed modification, what is meant by "to the extent prescribed"? Where is the detail to be found? Will a bespoke statement of affairs form be provided?

Paragraph 53 – in Chapter 3 reference is made to the procedural aspects of the SAR to be bought into effect through specific insolvency rules. When are the insolvency rules applicable to the SAR regime to be made available? We note that the client voting procedures and establishment of creditors' committee are to be addressed in these specific rules. Consideration should be given in this respect to clients who are also custodians. Typically custodians do not have the authority to exercise, or do not want the responsibility of exercising, any discretion in relation to the assets held by them, but it is often equally impractical to seek individual instructions from all of its clients, therefore in practice custodians are unlikely to attend relevant meetings in which case the voting majorities would not be truly representative of the client group.

Paragraph 99(3) - we think that the principle of the administrator's remuneration and expenses being charged on the client assets is appropriate, but suggest that the drafting needs to be clearer. In paragraph 3.9 of the consultation, it is suggested that the rules will provide for the costs to be borne by the clients in proportion to the size of their asset holding. We assume that clients who may have a sizeable holding but clear entitlement to the return of the assets, which can be achieved for little cost and effort on the part of the administrator, will not have to bear the costs of the administrator generally for returning other clients' assets? There may, however, be circumstances where the difficulties in the return of client assets arises as a result of a

failure to segregate on the part of the firm. In those cases it may be more equitable to apportion costs on a pro rata basis. This perhaps lends further support to the splitting of Objective 1 in two parts (the subject of question 3 above) to deal with assets segregated and those that are not. Alternatively, it is proposed that the administrator retains some discretion.

11. **Do you agree with the interaction of the SAR and the Bank Insolvency Procedure as set out above and in Schedule 1 to the draft regulations?**

We agree that some provision should be made for investment banks that are also deposit taking banks. The concept of the Special Administration (Bank Insolvency) procedure set out in Schedule 1 is a complicated, but perhaps necessary, approach. In particular, we agree that priority should be given to Objective A over the special administration objectives.

12. **Do you agree with the interaction of the SAR and the Bank Administration Procedure as set out above and in Schedule 2 to the draft regulations?**

Again we are in agreement that provisions should be made to deal with the interaction of the SAR and Bank Administration. We are concerned that the Special Administration (Bank Administration) is too complicated and may not be workable. In particular, drawing up a statement of proposals in a relatively short period of time when there is significant uncertainty and which is to be agreed by BOE, creditors and clients will be considerably challenging.

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?**

Having an operational reserve which is ring-fenced to ensure continuity of service is in principle a good idea, but commercially we think that it may tie up funds unnecessarily to cover, what is hoped to be, a relatively remote risk. We also consider that there will be practical difficulties in agreeing the level of reserves and also determining what constitutes key supplies in respect of any given firm.

Yours faithfully

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HM Treasury
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London, 16 November 2010

Special administration regime for investment firms

Dear Sir/Madam

This response is provided on behalf of Euroclear UK & Ireland Limited (***EUI***) which operates the CREST system, the UK's securities settlement system. EUI welcomes this opportunity to respond to the consultation regarding the proposed special administration regime for investment firms set out in the September 2010 paper (the ***consultation document***).

In this response we do not address all the questions raised in the consultation document. We have focussed our response on those areas of particular interest or concern to EUI or in relation to which EUI has knowledge and experience to contribute.

6 Do you agree with Objective 2 as set out in draft regulation 13?

Our primary concern relates to the scope of proposed cooperation provisions.

The proposals as currently set out would require an administrator to work with market infrastructure to facilitate the operation of the default rules of the market infrastructure bodies. Default rules refer to "rules of a recognised investment exchange or recognised clearing house which provide for the taking of action in the event of a person...appearing to be unable, or likely to become unable, to meet his obligations in respect of one or more market contracts connected with the exchange or clearing house" (see section 188 of the Companies Act 1989).

EUI is a Recognised Clearing House (***RCH***) (ie recognised in accordance with the Financial Services and Markets Act 2000) which does not enter into 'market contracts' (ie does not enter into contracts of the type mentioned in section 155(3) of the Companies Act 1989). This recognises the

fact that, although an RCH, unlike other RCHs EUI is not a central counterparty and is not itself a party to market contracts; rather, EUI operates the CREST settlement system which may facilitate the settlement of market contracts.

As a result of this, EUI is not required to have *default rules* and does not have any such rules (as is recognised in regulation 8 of the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001).

However, EUI is additionally a designated system in accordance with the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (***SFRs***). Under the SFRs, EUI is required to have *default arrangements* (ie arrangements put in place by a designated system to limit systemic and other types of risk which arise in the event of a participant appearing to be unable, or likely to become unable, to meet its obligations in respect of a transfer order (see regulation 2 of the SFRs)). EUI's default arrangements are set in the CREST Rules issued by EUI (see in particular CREST Rule 13).

It was in accordance with its default arrangements that EUI was able to take action in relation to the insolvency of Lehman Brothers International (Europe), including to take action to deal with pending unsettled transactions in the CREST system.

EUI **considers it essential** that the draft regulation 13 of the proposed regulations is extended to require administrators to work with market infrastructure to facilitate not only the operation of default rules, but also to facilitate the operation of default arrangements (within the meaning of the SFRs) of such bodies. **The absence of such a change would exclude EUI from the scope of the cooperation provisions.** This would seriously undermine the benefits to systemic integrity and effective, prompt resolution following an insolvency event.

We do not believe that the provision in relation to facilitating "settlement or prompt cancellation of non-settled market contracts" is sufficient to overcome these concerns. As currently drafted, it is not clear that the cooperation provisions would apply in relation to EUI at all.

Secondly, it is important to distinguish unsettled trades from pending settlement instructions in the CREST system. EUI has no powers in relation to the cancellation of unsettled market contracts and such cancellation is not within the scope of EUI's default arrangements. Unsettled trades must be dealt with in accordance with the terms of the trade between the parties or through the operation of the default rules of a relevant exchange or central counterparty. Pending settlement instructions are a means of discharging those trade obligations. Settlement instructions must be dealt with in order to provide certainty to the market, but cancellation of a settlement instruction has no impact on the status of the market contract itself. EUI's default arrangements relate to settling or

cancelling unsettled settlement instructions, but not to cancellation of non-settled market contracts.

Additionally, one of the significant area of pending unsettled settlement instructions was in relation to trades other than market contracts. We do not believe that engagement with EUI as operator of the CREST system should be restricted to settlement instructions in respect of market contracts, but should encompass all pending settlement instructions subject to EUI's default arrangements.

9 Do you agree that continuity of service provisions should be extended as set out above and in draft regulation 14?

In relation to participation in the CREST system, there are two additional suppliers which are essential for continued effective participation. Firstly, all communication with the CREST system is via secure data networks, operated by third parties independent of EUI. CREST participants must have in force a contract with an accredited network provider of their choice. We know from experience that credit issues can impact the ability of a participant to maintain their secure network link. Without such a link, CREST participants **will not be able to access the CREST system**, preventing them settling transactions or dealing with unsettled settlement instructions.

Secondly, certain CREST participants use the services of a third party to operate CREST system access on their behalf. Such participants are known as 'sponsored members', with the third party known as a 'CREST sponsor' (referred to as a 'sponsoring system-participant' in the terminology of the Uncertificated Securities Regulations 2001). It is again essential that sponsored members maintain an arrangement with their CREST sponsor, without which they will not be able to manage their CREST participation.

We do not believe that the current provisions in relation to "reception and transmission of orders in relation to securities" or "trading of securities" would cover settlement instructions into the CREST system (even where settlement instructions relate to such orders or trading). As noted above, there is a clear distinction between orders/trades in securities and settlement instructions in relation to such orders/trades.

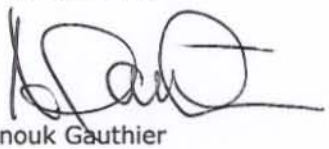
To be effective in the context of continued participation in the CREST system by an insolvent entity, the "supplier" definition would therefore need to include CREST accredited network suppliers and CREST sponsors.

Additionally, **it is essential that it is clear that EUI does not fall within the scope of "supplier"** for the purposes of draft regulation 14. Doubt may arise, for example, in relation to the supply of "computer software", "financial data" or "data processing". There must be no doubt

that continuity of service provisions do not interfere either with EUI's ability to suspend and/or terminate the participation of a CREST participant (including, for example, in circumstances where continued participation may represent a threat to the security, integrity or reputation of the CREST system, or where participation is disruptive to other CREST participants, registrars or issuers), or with the operation of EUI's default arrangements. We suggest that Recognised Bodies be excluded from the scope of "supplier".

If you have any queries with regard to the contents of this response, please do not hesitate to contact us.

Yours faithfully



Anouk Gauthier
For and on behalf of Euroclear UK & Ireland

Special Administration Regime for Investment Firms

A Response by the Futures and Options Association

NOVEMBER 2010

Special Administration Regime for Investment Firms

1. Introduction

1.1 The Futures and Options Association ("the FOA") is the principal European industry association for over 160 firms and organisations engaged in the carrying on of business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, clearing houses, IT providers, lawyers, accountants and consultants (see Appendix 1).

1.2 The FOA notes and supports the overall objective of the HM Treasury Consultation Paper on the "Special Administration Regime for Investment Firms" ("CP") to establish a special administration regime (SAR) for investment firms; ensure that there is "minimum disruption to financial markets as a result of their failure" and address many of the difficulties that were identified in administrating Lehman's insolvency. These include requiring the reconciliation of a firm's books and records, distinguishing client assets from house assets and calculating shortfalls in and expediting the return of client assets and money.

1.3 It is also important for the new regime to ensure that, in the event of default, effective management of the conflicts and priorities that exist between the regulatory authorities, which wish to preserve the integrity of the system and market and investor confidence, the clearing houses, which will wish to maintain the integrity of their default funds, clients, who will wish to see their positions and the associated collateral transferred in a timely manner, and the administrators whose primary objective is to realise the assets of a failed investment firm in the best interests of the creditors of the defaulting firm. The FOA notes that the Objectives and the FSA's powers of direction will go some way to ensuring that these conflicts will be effectively managed.

1.4 The FOA supports the view of the Association for Financial Markets in Europe (AFME) that HM Treasury should expand the scope of the Banking Act 2009 to include resolution powers for all investment firms where necessary to protect the stability of, or to enhance confidence in, the financial system, including empowering the authorities to restructure a failing financial bank so that it can be maintained as a going concern in appropriate circumstances.

1.5 The FOA also notes and supports the various initiatives to improve cross-border co-operation and secure host-state recognition of insolvency law, but it is likely that there will need to be a higher degree of convergence in approaches before meaningful recognition can be accommodated. The enactment of EMIR as a Regulation is helpful in this regard.

2. Responses to specific questions

2.1 It is clear from para 2.6 of the Consultation Document that the proposed SAR for scope of investment firms will exclude certain fund managers, insurance intermediaries, advisors and brokers, even though they may hold client assets including, for these purposes, client money. It is not clear, however, whether the Government's policy is to catch all regulated entities which hold client assets (including money) or just those which fall within the restricted definition of an investment bank as set out in section 232 of the Banking Act 2009. If the latter, then potentially firms whose authorisation is limited to arranging deals in investments but who are also authorised to hold client money and assets would be

outside the definition of an "investment bank". The FOA urges the Treasury to think "beyond Lehmans" and consider including any holder of client assets in the SAR, since, the next failure is likely to come from a different, if not wholly unexpected, source.

2.2 The FOA supports the Treasury view (which is line with recent case law) that "client assets" will include both assets and money (except where noted in the Regulations themselves). The Regulations need to be clear that this include "safe custody assets" for the purposes of CASS 6 as well as "client money" as defined by the FSA rules.

Q1. (a) 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 assets" includes client money?

2.3 Yes.

2.4 The FOA is unclear, however, as to whether assets held on a contractual basis in other jurisdictions, particularly those that do not recognise the trust structures, provide a similar level of segregation to money held by the defaulting firm as that provided by the FSA Client Assets sourcebook and can therefore be afforded the same level of protection as if they were "client assets" under the SAR regime.

2.5 The revised draft Order provides that a "client" means a person for whom the investment bank has undertaken to hold client assets (whether or not on trust and whether or not that undertaking has been complied with). This will include not only assets (including money) held subject to a statutory or express trust but also assets held on other terms such as bailment and assets which the client can establish a proprietary interest in whether or not the firm complied with the terms of that trust (para. 2.8) This necessarily brings both elements of subjectivity and uncertainty as clients may be required to prove the legal basis on which assets were or were intended to be held on that basis before establishing a claim on the firm's estate or that those assets were intended to be held on that basis in order to maintain their claim. See Moriarty v B.A. Peters [2008] EWCA Civ 1604.

This is also precisely the basis on which the Joint Administrators of Lehman Brothers International Europe have sought to appeal the Court of Appeal's ruling to the Supreme Court in that one of the consequence of the Court of Appeal's decision is that the Joint Administrators will not be able to make a timely return of client money because the Joint Administrators will have to embark on an exercise that will involve identifying entitlements to client money and to add identifiable but not segregated client money to add to the client money pool. (http://www.pwc.co.uk/eng/issues/lehman_client_money_update_270910.html) We believe that the previous version of this provision was probably clearer.

The FOA would refer to the need for clarity and consistency in referring to "investment banks" and "investment firms".

Q1. (b) Will amending the order as described cover all the ways in which an investment firm can hold client assets?

2.6 The FOA believes that the class of assets caught within the definition of Client Assets is adequate, but the "whether or not on trust" wording could be interpreted as having the inadvertent and unfortunate consequence of extending the definition.

As with the case of Lehman Brothers International Europe, in order to fulfil Objective 1 of the SAR, the administrator would be required to establish what constitutes "client assets" whether by setting up a claims process as outlined in Regulation 11 of the draft regulations or otherwise through the firm's own books and records. However, if those

books and records are deficient, then the administrator may be left in the position of having to establish the basis and possibly even whether the firm intended to hold those assets as client assets. Although the SAR provides that the FSA may make directions in order to achieve the various objectives, it is unlikely that FSA would wish to be in the position of having to substitute its judgment for those of the courts in deciding whether or not certain assets (including money) were client assets within the meaning of the Regulations.

Q1. (c) Would adapting the provision of the SAR to apply in respect of LLPs or partnerships raise any significant consequences?

2.7 The FOA is unclear as to whether or not extending the provisions of the SAR to apply to LLPs or partnerships would have any significant consequences in terms of achieving the objectives of the special resolution regime. Since some investment firms may elect to be LLP or other forms of partnerships, it seems right that the regime should apply to all investment firms irrespective of their constitution, although there may be certain additional provisions that may have to be introduced in order to make it fair and proportionate particularly where, in the case of partnerships, individual partners may be liable for the debts of the partnership which can lead to individual bankruptcy.

Q2. Do you agree with the proposals for initiative of the SAR, as set out above and in draft regulations 4 to 8?

2.8 Yes. The grounds for initiating the SAR, i.e. inability to pay debts or because it would be fair or expedient in the public interest to put the investment bank into special administration seem logical but this language does give the FSA and, if applicable the Secretary of State, very broad powers to invoke the SAR. Although these grounds are similar to those in section 124A of the Insolvency Act (see In re Inertia Partnership LLP (unreported) they arguably introduce another standard for the factors taken into account in determining whether the SAR should be involved. For example, in order for FSA to invoke its powers to winding up an authorised firm under s. 367 of FSMA such action must be "just and equitable". See also FSA Final Notice re: Graham Darby (6 July 2009) where a firm was wound up on FSA's application on the basis that the sole director and/or shareholder of Ambrose Darby appeared unwilling and/or unable to properly administer the affairs of the firm including the management of its client money and other assets and therefore it failed to comply with the threshold requirements and standards of the regulatory regime that it was subject to as an authorised firm under the FSMA. It would be useful to have a consistent test for initiating the SAR rather than having to argue from or distinguish other statutory provisions (FSMA and Insolvency Act 1986) by analogy.

2.9 The FOA supports the requirements of prior notice to and consent from the FSA before the SAR can be initiated although, with the Government's proposals to reform the regulatory framework, it will be necessary to consider whether these requirements should be given to the Prudential Regulation Authority as part of its financial stability remit or whether it should be part of the Consumer Protection and Markets Authority's supervisory powers or both.

Q3. Should the scope of Objective 1 be amended in either of the ways set out in paragraph 2.23?

2.10 In general terms, the FOA agrees with the three Special Administration Objectives for Administrators as set out in para 2.19.

2.11 The FOA agrees with the proposed amendment to Objective 1 set out in para 2.23, but also believes that there should be some governing criteria as to how the option should be exercised to ensure, firstly, that there is consistency and, secondly, that it would not

operate to the undue prejudice of other interested parties – including unsecured creditors (and the FOA assumes that the FSA's power of direction will extend to how the option should be exercised).

2.12 It is also important to note that this Objective does not apply to client money (Regulation 11(8)) which would continue to be distributed in accordance with the FSA's Client Money distribution rules and therefore be subject to some of the same ambiguities that have arisen in the case of Lehman Brothers International Europe.

Q4. Do you agree with the bar dates proposal as set out in draft regulation 11?

2.13 Yes, we are in favour of requiring court approval to both set a bar date and as to the actual date itself, but it would also seem appropriate to allow the owner of client assets (or, indeed, the FSA) a right to seek an extension in the bar date in order to address any situation where a beneficial owner may not, for good reason, be able to meet the bar date or seek an individual extension in time.

2.14 However, the draft Regulation does not apply if the assets in question are one which should have been held by the investment bank in accordance with rules made under section 139 of FSA (the Client Money Rules) (Regulation 12(1)(b)). CASS 7A does not currently have any provision for bar dates and FOA believes that there should be equivalent powers in the FSA Client Money Rules to limit the time within which claims on the client money pool may be brought.

Q5. Do you agree with the allocation of shortfalls proposal as set out in draft regulation 12?

2.15 Yes.

Q6. Do you agree with Objective 2 as set out in draft regulation 13?

2.16 This is a particularly important objective, insofar as it should help to manage/reconcile the inherent conflict in priorities that exist between market infrastructures, the regulatory authorities and the administrator.

2.17 With regard to 2.36, the FOA supports the definition of "work with", but believes that it should include a specific requirement that the administrator will provide "timely" access for market infrastructure bodies and authorities to the facilities and premises of the investment firm (NB. It is noted that the words "as soon as is reasonably practicable" are used in relation to the parallel requirement regarding provision of information or production of documents).

2.18 However, the draft regulation does seem to provide a "get out" clause for the administrator in that it provides that "no action need to be taken in accordance with this paragraph to the extent that, in the opinion of the administrator, such action would lead to a material reduction in the value of the property of the investment banks." The Regulation does not appear to provide any means for mediating this process of 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) if the "get out" clause is invoked by the administrator.

Q7. Do you agree with Objective 3 as set out in draft regulation 10?

2.19 Yes.

Q8. Do you agree with giving the FSA a power of direction as set out above and in draft regulations 16 to 20?

2.20 Yes – and this is consistent with the prioritisation of sustaining market stability and the integrity of the financial system, which is a key concern for the Government in the restructuring of the FSA and establishing the new regulatory framework. Clearly, the various powers given to the FSA will need to be reconfigured to fit with any new regulatory structure that is put in place as a result of the current consultation on the future of the FSA.

2.21 The FOA also agrees that the FSA, when exercising its powers under draft Regulations 16 to direct the administrators to prioritise one or more of the Objectives, should be required to set out its reasons for giving the direction and to consult with HM Treasury and the Bank of England. However, the Bank of England (and the Financial Policy Committee) should be in a position to be more than just "consulted", where, for example, the decision is designed to mitigate macro-economic risk or risk posed to, or which has consequences for, the financial system, e.g. where the firm in question is systemically important.

Q9. Do you agree that the continuity of service provisions should be extended as set out above and in draft regulation 14?

2.22 Yes. The post-default continuance of the supply of IT and other key services and the retention of essential staff is critical. For this reason, the FOA supports the establishment of an operational reserve to ensure that continuity of service (see para 2.65). However, in the event of dissipation of that reserve for whatever reason, the FOA does not believe that suppliers of staff need any more protection than the administration expenses regime and should not, therefore, be singled out for special treatment. If they are expenses, they would rank above the administrator's remuneration in any event.

The FOA would urge close consultation on the list of supply services to ensure that there are no omissions and that it is sufficiently comprehensive to ensure a bank can continue in business (e.g. the provision of hardware services).

2.23 The FOA would also suggest that the FSA Rules on outsourcing (SYSC 8) should also reference these requirements to ensure that suppliers are aware of these requirements and that outsourcing agreements contain appropriate provisions to ensure that these requirements can be invoked. It is worth noting, however, that the scope of Regulation 14 is potentially both wider than SYSC 8 in the sense that it is not limited to outsourcing of critical functions and narrower in the sense that some of the services included in the definition of supply would be carved out of SYSC 8.1.5 (eg. standardised services). In other words, while the linking reference to the FSA Rules would be useful, we don't think the scope of the two provisions is the same and this should be made clear.

Q10. Do you agree with the modifications to Schedule B1 administration as set out above and in draft regulation 15?

2.24 In general terms, the FOA agrees with the proposed modifications.

2.25 The FOA agrees with the conclusion that the new Objectives and the FSA's powers of direction will help to mitigate the personal liability of administrators and the risk of legal challenge and we do not believe that an administrator needs any more protection than they currently have (or would have under the proposed SAR). Nevertheless, as the paper rightly anticipates in para 2.48, the complexity and scale of the insolvency of an investment firm carries a very high potential for substantial personal liability and that liability is greater by virtue of the fact that clients have now been added to those who can

bring an action against an administrator. It is likely, therefore, that administrators will seek, on a continuing basis, directions from the FSA and the Court, notwithstanding the new objectives and the flexibility that is afforded to them. This could have the adverse consequence of slowing down the process of increasing the cost of administration.

Q11. Do you agree with the interaction of the SAR and Bank Insolvency Procedure as set out above and in Schedule 1 to the draft regulations?

Q12. Do you agree with the interaction of the SAR and the Bank Administration Procedure as set out above and in Schedule 2 to the draft regulations?

2.26 The FOA broadly supports the concept of the proposed interaction between the SAR and the Bank Insolvency Procedures and Bank Administration Procedures, but clarity around the interaction of the provisions, regime boundaries and the consequences of restructuring the FSA into separate authorities will need to be addressed.

2.27 Schedule 1 and 2 of the Regulations only apply where the "investment bank" is also a deposit taking bank (Schedule 1 Para.1) or when part of the business of the deposit-taking bank is to be sold to a commercial purchaser or transferred to a bridge bank (Schedule 2, para. 1) and the Government has proposed new "Special Administration (Bank Insolvency) procedures which would provide a half-way house between the Bank Administration Procedure and the Special Administration regime for investment banks.

2.28 In many (but not all) cases, investment firms which meet the definition of an "investment bank" in s. 232 of the Banking Act 2009 are institutions which have permission under Part IV of the Financial Services and Markets Act 2000 to carry on the regulated activity of:

a) safeguarding and administering investments

(b) dealing in investments as principal, or

(c) dealing in investments as agent

but which, although holding client assets, will not be authorised for deposit taking activities. As a result, this alternative approach is likely to have limited application.

It is unclear, whether this approach is intended to introduce resolution powers in the broader context of investment firms and we would welcome clarification of HM Treasury's intentions in this regard.

2.29 The complexity of this proposed regime may cause difficulties in respect of already complex structural and factual situations and we would stress again the need for greater clarity around the relationship between the SAR and the Banking Act.

The FOA believes that administrators should be able to have a legal and regulatory framework that ensures that the Special Administration Objectives can be met without having to make frequent and costly applications to the Court for directions other than where is necessary.

Q13. 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?

2.30 The FOA agrees that the operational reserve should be:

- ring-fenced, in order to provide assurance post-default, that costs and fees will be paid to suppliers and staff to maintain continuity of service; and

- restricted to this objective, bearing in mind the severe increase in capital rules and prudential add-ons that are already being faced by authorised institutions.

APPENDIX 1

List of FOA Members

FINANCIAL INSTITUTIONS

ABN AMRO Clearing Bank N.V.
ADM Investor Services International Ltd
AMT Futures Limited
Bache Commodities Limited
Bank of America Merrill Lynch
Banca IMI S.p.A.
Barclays Capital
Berkeley Futures Ltd
BGC International
BHF Aktiengesellschaft
BNP Paribas Commodity Futures Limited
Capital Spreads
Citadel Derivatives Group (Europe) Limited
Citigroup
City Index Limited
CMC Group Plc
Commerzbank AG
Crédit Agricole CIB
Credit Suisse Securities (Europe) Limited
Deutsche Bank AG
ETX Capital
Fortis Bank Global Clearing NV - London
GDI Markets Limited
GFI Securities Limited
GFT Global Markets UK Ltd
Goldman Sachs International
HSBC Bank Plc
ICAP Securities Limited
IG Group Holdings Plc
Investec Bank (UK) Limited
JB Drax Honoré
JP Morgan Securities Ltd
Liquid Capital Markets Ltd
LMAX Limited
Louis Capital Markets UK, LLP
M & G Investment Management Ltd
Macquarie Bank Limited
Mako Global Derivatives Limited
MF Global
Marex Financial Limited
Mitsubishi UFJ Securities International Plc
Mizuho Securities USA, Inc London
Monument Securities Limited
Morgan Stanley & Co International Limited
Newedge Group (UK Branch)
Nomura International Plc
ODL Securities Limited
Rabobank International
RBS Greenwich Futures
Royal Bank of Canada
Saxo Bank A/S
S E B Futures
Schneider Trading Associates Limited
S G London
Standard Bank Plc
Standard Chartered Bank (SCB)
Starmark Trading Limited
The Bank of Nova Scotia
The Kyte Group Limited
Tullett Prebon (Securities) Ltd
UBS Limited
Wells Fargo Securities International Limited
WorldSpreads Limited

EXCHANGE/CLEARING HOUSES

APX Group
Bahrain Financial Exchange
CME Group, Inc.
Dalian Commodity Exchange
EDX London
European Energy Exchange AG
Global Board of Trade Ltd
ICE Futures Europe
LCH.Clearnet Group
MEFF RV
NYSE Liffe
Powernext SA
RTS Stock Exchange
Shanghai Futures Exchange
Singapore Exchange Limited
Singapore Mercantile Exchange
The London Metal Exchange
The South African Futures Exchange

SPECIALIST COMMODITY HOUSES

Amalgamated Metal Trading Ltd
ED & F Man Commodity Advisers Limited
Engelhard International Limited
Glencore Commodities Ltd
Koch Metals Trading Ltd
Metdist Trading Limited
Mitsui Bussan Commodities Limited
Natixis Commodity Markets Limited
Noble Clean Fuels Limited
Phibro GMBH
RBS Sempra Metals
Sucden Financial Limited
Toyota Tsusho Metals Ltd
Triland Metals Ltd
TRX Futures Ltd
Vitol SA

ENERGY COMPANIES

Accord Energy Ltd
Atel Trading AG
BP Oil International Limited

ChevronTexaco
ConocoPhillips Limited
E.ON EnergyTrading SE
EDF Energy
EDF Energy Merchants Ltd
Gaselys
International Power plc
National Grid Electricity Transmission Plc
RWE Trading GMBH
Scottish Power Energy Trading Ltd
Shell International Trading & Shipping Co Ltd
SmartestEnergy Limited

PROFESSIONAL SERVICE COMPANIES
Ashurst LLP
Baker & McKenzie
Barlow Lyde & Gilbert
Berwin Leighton Paisner LLP
BDO Stoy Hayward
Clifford Chance
Clyde & Co
CMS Cameron McKenna
Complinet
Deloitte
Denton Wilde Sapte
Eukleia Training Limited
Exchange Consulting Group Ltd
FfastFill
Fidessa Plc
Financial Technologies India
FOW Ltd
Freshfields Bruckhaus Deringer
Herbert Smith LLP
Hunton & Williams LLP
International Capital Market Association
ION Trading Group
JLT Risk Solutions Ltd
Katten Muchin Rosenman Cornish LLP
KPMG
Mpac Consultancy LLP
Norton Rose LLP
Options Industry Council
PA Consulting Group
Pekin & Pekin
R3D Systems Ltd
Reed Smith LLP
Rostron Parry Ltd
RTS Realtime Systems Ltd
Sidley Austin LLP
Simmons & Simmons
SJ Berwin & Company
Speechly Bircham LLP
SunGard Futures Systems
Swiss Futures and Options Association
Total Global Steel Ltd
Travers Smith LLP
Trayport Limited

Investment Management Association

ima

Daniel Okubo
Financial Regulatory Strategy Team
HM Treasury

By email only to daniel.okubo@hmtreasury.gsi.gov.uk

15 Nov. 10

Dear Daniel,

The IMA's[1] response to the consultation: Special administration regimes for investment firms is set out below. We have had input before the consultation was drafted and have continued the conversation throughout; many of our points have already been taken on board. If we can be of further help do not hesitate to contact us.

Kind regards

Guy Sears
Director, Wholesale

Question 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?

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[1] The IMA represents the asset management industry operating in the UK. Our Members include independent fund 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 over £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.

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Yes. But there is still the issue as to the meaning of client asset. If it turns out that client assets include assets that have not been segregated then there will be circumstances in which an administrator will not in practice be able to distribute rapidly. In any situation in which a significant amount of client assets has not been segregated, even the availability of a bar date will not expedite distribution.

Will amending the order as described cover all the ways in which an investment firm can hold client assets?

Our reading of the proposal is that this is an evidential provision. We presume that an entry on the FSA register which identifies the authority to hold or control client assets will not be conclusive that the firm meets this requirement. At present the FSA register does not distinguish between the situation where a firm might *control* client assets but not *hold* client assets. Even if the FSA developed separate authorisations, many firms may need to retain an authority to hold client assets because there are legacy entitlements in companies that are undergoing long-term restructuring and have no market or extrinsic value beyond an entitlement to receive a distribution in due course. We would imagine the materiality of such holdings and the fact that their return to a client would involve a transfer of title for which court order were needed (as is the case where the issuer is in liquidation), will bear upon the question as to whether the SAR is used.

Would adapting the provisions of the SAR to apply in respect of limited liability partnerships (LLPS) or partnerships raise any significant consequences?

We have not identified any.

Question 2

Do you agree with the proposals for initiation of the SAR, as set out above and in draft regulations 4 to 8?

Yes.

Question 3

Should the scope of Objective 1 be amended in either of the ways as set out in paragraph 2.23?

We support flexibility in objective 1 so that the return of client assets can be dealt with on a pool by pool basis and can also have regard to whether there should be a return of some assets notwithstanding that there is a dispute over the other assets. If the language needs to be amended to make that clear we would support it; an administrator should not fear criticism for prioritising some types of client assets (such as those segregated at a particular custodian) over others whose resolution will likely be over a much longer timeframe. We have discussed this with you during the consultation.

We do have a qualification about objective 1 as set out. We understand that the regulation will not apply if the investment bank is itself providing custody services. We wonder whether that is a distinction that is appropriate. This we think arises because the proposed

definition of client omnibus account is that it must be held with another institution in the name of the investment bank and therefore will not cover accounts held by the investment bank as a custodian.

We have raised this with you during the consultation and understand that revised drafting will ensure self-provision of custody will be covered.

Question 4

Do you agree with the bar dates proposal as set out in draft regulation 11?

Yes. It is said that the rules will ensure that the administrator should approach claimants which appear from the books and records to have a claim. That seems to us an important protection if bar dates are to be imposed. Given the rulemaking power is "at-large", we would support any particularisation which made it clear that the intention was that administrators could not merely advertise for claims.

Question 5

Do you agree with the allocation of shortfalls proposal as set out in draft regulation 12?

Yes but we think that the reference to trading prices is overly detailed in one particular area of coverage, that of securities for which a price is published by the Financial Times. There will in nearly every single case an existing course of conduct as regards the valuation of securities. Sometimes these are clean data feeds and sometimes level II and level III information must be used. We think administrators should determine a fair market value based upon the same methodology in existence immediately before the administration. If therefore an agreed model was being used, it should still be used. We think in this way the regulations could be a more all-encompassing, better express the principle to be followed, and give a far more predictable result related to the position immediately before administration compared with switching the manner in which the security is priced in order to fit in with the regulation as proposed.

So perhaps definition of market price could state (reputable might be added to so to encompass reliable as well):
"(a) the value of the security on the day in question as determined by a reputable source used by the investment bank immediately prior to the administration for valuing or reporting in respect of that client asset; or, if this is not practicable,
(b) the value of the security on the day in question as determined by the administrator that reflects the fair value price for that security."

Question 6

Do you agree with Objective 2 as set out in draft regulation 13?

Yes. It is important that it is not forgotten that duties also exist under the Companies Act 1989.

Question 7

Do you agree with Objective 3 as set out in draft regulation 10?

Yes.

Question 8

Do you agree with giving the FSA a power of direction as set out above and in draft regulations 16 to 20?

Yes.

Question 9

Do you agree that the continuity of service provisions should be extended as set out above and in draft regulation 14?

In principle, yes. The actual list of supplies covered by regulation 14(5) may need to be developed. Would the data feeds for valuations be considered to be part of financial data? Also data feeds and other external services such as fund accounting relating to the holding and administration of client assets needs to be part of the definition of supply. If hardware is held under lease agreements and the hardware is needed to run the software or process data, that supply should be continued.

The provision in regulation 2(b) preventing greenmail ought to be competent for most purposes but still reflects its origin in power supplies in individual insolvency. Some data suppliers will be required to provide ad hoc reports or resend data to the administrator; the provision should allow them to be paid for it but not extract an inappropriate payment. This may be impossible to address in legislation.

The reference in 5(a) to trading of securities might be replaced by dealing in the securities as this better reflects the regulated activities. As regards reception and transmission of orders, the current draft regulation has a comma after the word reception. This is technically incorrect if this is intended to refer to the regulated activity of reception and transmission where the word and is used conjunctively.

Question 10

Do you agree with the modifications to Schedule B1 administration as set out above and in draft regulation 15?

Yes.

Question 11

Do you agree with the interaction of the SAR and the Bank Insolvency Procedure as set out above and in Schedule 1 to the draft regulations?

Yes.

Question 12

Do you agree with the interaction of the SAR and the Bank Administration Procedure as set out above and in Schedule 2 to the draft regulations?

Yes, save that the application of section 145 does not require the qualifying words in (b)(iii) as the special administration application cannot be made by the FSA.

Question 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?

In principle, yes. We are unsure however how this will interact with European directives on the level of capital required to be held by an investment bank.

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SUBMISSION IN RESPONSE TO HM TREASURY CONSULTATION PAPER ON A "SPECIAL ADMINISTRATION REGIME FOR INVESTMENT FIRMS"

1 Introduction

Linklaters is pleased to respond to HM Treasury's Consultation Paper published on 16 September 2010, containing proposals for a special administration regime ("**SAR**") for investment firms and a draft statutory instrument containing the Investment Bank Special Administration Regulations 2011 (the "**Regulations**"), which invited specific responses to the questions raised by the Consultation Paper by 16 November 2010.

Linklaters is one of the leading premium global law firms. We undertake important and challenging assignments for the world's leading companies, financial institutions and governments, helping them to achieve their objectives by solving their most complex and important legal issues. This submission draws on our very extensive restructuring and insolvency experience, particularly in relation to our role in advising the administrators of various Lehman Brothers entities.

2 General comments

We agree that there is a clear need for a special insolvency regime for investment firms and are broadly supportive of the proposals set out in the Consultation Paper. Rather than respond to each question, we have instead set out our comments on a number of specific points.

Overall, we think it would be helpful if some form of guidance note could be produced (i) explaining how the new SAR, and its variations as set out in Schedules 1 and 2 of the Regulations, will operate alongside existing insolvency regimes (particularly where an investment bank is also a deposit-taking bank) and (ii) indicating where relevant definitions (such as 'client assets') are to be found. One example of an area where such guidance could prove helpful is set out at point 3.4 below.

3 Specific comments

3.1 Split Objective 1

The current draft of Regulation 10(1)(a) states that "Objective 1" should be "to ensure the return of client assets as soon as reasonably practical". We would support the proposal that Objective 1 should be split into two parts, so as to make it clear that an administrator would be allowed to return segregated client assets in priority to those which were not segregated.

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.

By way of illustration, more than three quarters of segregated client assets have now been returned in the Lehman administration.

It is important that the proposed SAR (the objectives of which are to provide administrators with clarity and to increase the confidence of clients and counterparties in any administration process) should not either potentially worsen the current position for clients with segregated assets or leave administrators uncertain as to how they may properly proceed.

If Objective 1 was, as currently drafted, simply to return client assets as soon as is reasonably practicable, our concern would be that an administrator who focussed 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.

Any such challenges would inevitably lead to additional costs and uncertainty, even if the court were eventually to decide that, under the single objective, an administrator may deal with client assets as he or she considers appropriate.

Accordingly, our view is that it would be beneficial to split Objective 1, as suggested in the Consultation Paper, so that it is made clear that the administrator has the power to return segregated client assets in priority to those which are not segregated, as this should result in speedier returns than the more general objective of returning client assets.

3.2 Bar dates

We support the proposal that an administrator should be able to set a bar date for the submission of claims to client assets, in order to accelerate the return of client assets. This is a very helpful concept.

We are not clear, however, what role the court should have – or indeed whether it should have any role – in approving the distribution of client assets after any such bar date (Regulation 11(4)(b)). The need to go to obtain court approval in relation to the process of distributing client assets also appears at odds with the disapplication (by Regulation 15) of paragraph 65(3) of Schedule B1, which removes the need to obtain court approval when an administrator is making a distribution to creditors.

If, once the administrator has determined the amount and timing of any proposed distribution, the proposed role of the court would simply be to ensure that the administrator has complied with the relevant notification requirements for the bar date (to be set out in the insolvency rules) then this additional step seems

unnecessary. If, on the other hand, the intention is that parties other than the administrator should have a right to attend the court hearing and to raise objections (for example, as to the valuation of any contingency or the treatment of a disputed claim), it would seem that the proposal could simply invite additional litigation – any aggrieved creditor already has the opportunity to challenge the administrator's conduct.

Turning to what may be a drafting point, Regulation 11 refers to both "*the return of client assets*" and the "*distribution of client assets*". While we do not believe that the difference in terminology is intended to be significant, it might be helpful if the terminology were consistent. Since the phrase "*return of client assets*" is defined in the draft regulations, we think that Regulation 11 should use that phrase throughout, given that the term "distribution" is generally used in the context of a payment using a company's own assets.

Finally, draft Regulation 11(5) states that the insolvency rules shall prescribe how any late claim made by a creditor with a proprietary claim should be treated by the administrator. We think that it is important that those rules should make it clear whether or not any such creditor would, to the extent that they suffered any loss, be entitled to prove in any subsequent distribution as an unsecured creditor.

3.3 Continuity of supply

We support the proposed extension by Regulation 14 of the existing continuity of supply provisions found in section 233 of the Insolvency Act 1986. However, we have concerns about Regulation 14's current intended scope and applicability, in relation to the supply of commercial bank services.

Regulation 14(5)(e) provides that "commercial bank services" are to be within the scope of the regulation, but that the supply of uncommitted credit is excluded. This suggests that committed credit is included and, accordingly, that a lender who has made available a committed, but undrawn, facility would be unable to terminate that lending commitment. This could potentially catch on demand overdraft facilities and revolving loans.

We would suggest that greater clarity is required in relation to the following points:-

- Which services would a bank be required to continue to provide?
- If a committed facility contains usual conditions removing the borrower's ability to utilise that facility after the commencement of administration, would any such conditions be disapplied?
- Can amounts repaid under a revolving facility by the borrower after the commencement of the administration be redrawn, and, if so, what conditions can be applied by the lender? and
- Will any resulting loss suffered by the relevant bank be an expense of the administration? We would suggest that Regulation 14(4), which appears to be intended to cover this point, does not clearly state that this would be the case.

It is probably also worth pointing out that the potential benefits anticipated by Regulation 14 may, in practice, be limited, as it would be quite simple for a supplier to avoid the consequences of Regulation 14, as currently drafted. The prohibition on

exercising a contractual termination right only arises after the commencement of special administration; an agreement could therefore attempt to get round this provision by including a right to terminate (or an automatic termination provision) where any step is taken to put the investment bank into the SAR. It may therefore be necessary, if Regulation 14 is to be effective, to include an additional clause rendering void any provision which allows the termination of such supply agreements on the grounds that anything is done with a view to putting an investment bank into special administration. Similar wording currently appears in paragraph 43 of Schedule A1 in relation to the crystallisation of floating charges.

3.4 Interaction of the SAR with the Banking Act 2009

Where a deposit-taking bank is also within the scope of the SAR, the consultation paper (paragraphs 2.52 - 2.64) suggests that a number of insolvency options should potentially be available, as the bank could be put into the Bank Insolvency Procedure or Bank Administration Procedure as set out in the Banking Act 2009 (the "**BA**") or, as an alternative, it could instead be put into a new Special Administration (Bank Insolvency) procedure or Special Administration (Bank Administration) Procedure.

Schedule 1 (*special administration (bank insolvency)*) is, however, stated to contain a procedure "*to be used as an alternative to special administration where the investment bank is a deposit-taking bank*", while Schedule 2 (*special administration (bank administration)*) contains a procedure "*to be used as an alternative to special administration*" where there has been a transfer of the deposit-taking bank's business to a commercial purchaser or bridge bank under the BA. It is not clear whether the procedures set out in these Schedules are also intended to offer an alternative to the existing Bank Administration Procedure (or Bank Insolvency Procedure).

It might also be helpful if the procedures set out in these Schedules are expressly stated to be alternative options to the SAR, rather than procedures which apply instead of the SAR - Regulation 9 states that if an investment bank is also a deposit-taking bank then Schedule 1 and Schedule 2 apply, the use of the word "apply" suggesting that the application of these Schedules may be mandatory rather than optional.

Linklaters LLP

16 November 2010

HMT consultation on special administration regime for investment firms

16 November 2010

Submitted by email to: daniel.okubo@hmtreasury.gsi.gov.uk

INTRODUCTION

The London Stock Exchange Group (LSEG) welcomes the Consultation and supports the aim of the Government in seeking to mitigate some of the problems that have arisen as a result of large scale insolvencies, including that of Lehman Brothers International (Europe) ("LBIE"). LSEG has significant practical experience of the impact of that insolvency; LBIE was one of its largest trading firms and the London Stock Exchange has been managing the default in respect of unsettled non-CCP trades since 15 September 2008; the process is still ongoing. One key issue has been the impact of the fragmented market on the identification of trades and where they were traded.

Based on this experience we comment below on some aspects of the Consultation Paper. In summary we believe:

1. The objectives of the proposed special administration regime (SAR) are appropriate, but it must be recognised that other areas of the resolution arrangements, in particular the records upon which the administrator's appointment and decisions will be based, must also be addressed if clients and counterparties are to have greater confidence in the administration process;

2. The scope for the SAR is potentially confusing and requires clarification;

3. The concept of bar dates should be incorporated into Part 7 of the Companies Act 1989;

4. Continuity of supply is key to ensuring the effective administration of a firm but needs to be considered in the context of wider 'living will' arrangements.

1. Objectives of SAR

We support the stated objectives of the proposed SAR – to provide clarity and direction to administrators and give clients and counterparties greater confidence in the administration process. However, both of these objectives

will also be dependent on the extent to which the other issues raised in the Government's consultation on 'Establishing resolution arrangements for investment banks' in December 2009 are also addressed.

In particular, Chapters 4 (Reconciling and returning client money and assets) and 6 (Reconciling counterparty positions) outline issues that are central to providing clarity and certainty to both clients and counterparties. This includes differentiating client vs. house assets, understanding contracts and master agreements and the problems of uncertainty caused by fragmented (equity) markets and the applicability (or not) of default rules.

In the case of the LBIE insolvency, these issues were exacerbated by the poor quality of record keeping, both by LBIE and by clients/counterparties. This was, and continues to be, a key reason for the difficulties faced by the Insolvency Practitioners and other firms in managing the default and agreeing the scope of which trades were on or off exchange. Unless firms keep clear and accurate records of what they have done, for/with whom and what basis, the ability to implement the SAR and deliver the benefits suggested will be limited.

It is, therefore, vital that the Government continues its efforts to take steps to improve outcomes for the clients/counterparties of a failed investment firm continue by increasing the quality of record keeping.

2. Scope of SAR

We consider the scope of the SAR confusing and, despite the inclusion of the conditions to be satisfied, do not believe it is as straightforward as it should be to establish who is to be covered by the proposed regime. We believe that there needs to be clarity so that the market understands and has certainty on this. We have the following observations:

a. The interchangeable use of the terms 'investment firm' and 'investment bank' is not helpful. The use of the latter term (and this is the term used in the Draft Regulation, although not in the consultation paper) suggests a regime intended to cover systemically important financial institutions;

b. However, the wording of the conditions, in particular that firms which are authorised to carry out dealing in investments as agent could be caught, suggests that the scope of the SAR could (subject to other conditions being met) also cover much smaller firms, which do not pose a risk to the financial system and for which many of the proposals would not make sense.

c. Most of the conditions proposed reflect the status of an investment firm, e.g. Part 4 permission, authorised activities, UK incorporation. However, the condition relating to the holding of client assets is a factual rather than status issue and, therefore, to the extent that this has to be established as a fact, 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.

3. Bar dates

We support the establishment of the concept of bar dates to accelerate the process of returning client assets and money. Based on our experience of the LBIE default, we would like to see this concept extended to the operation of default rules by recognised bodies. In a fragmented market, where there is no definitive record of trades, the lack of any cut-off date for the submission of claims by counterparties is one of the reasons that the calculation of net amounts due under the LSE's default rules in the LBIE insolvency is taking such a long time.

We propose that an amendment is made to Part 7 of the Companies Act 1989, such that recognised bodies have the ability to apply similar bar dates in a default process.

4. Continuity of supply

We agree that continuity of supply is key to ensuring the effective administration of a firm and that there should be rules allowing the administrator to use assets to pay the costs of continuing connection/services, even where this may be detrimental to the estate. (Cross border enforcement of this type may be subject to the usual issues that arise in this area.)

While the supply of IT and other key services are important, we suggest that this is also considered in the context of wider business planning and ay possible 'living will' arrangements which focus on how operations would be resolved in an orderly fashion in the case of insolvency.

We also suggest that firms could be required to include continuity of service provisions in their relevant contracts for key services to the effect that certain services and providers are designated as "default/failure critical" and the firm would need to ensure that the providers actually committed to continued delivery post-insolvency.

Special administration regime for investment firms
HM Treasury September 2010

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HOW LONG IS A CHAIN OF DERIVATIVE CONTRACTS?

"The Government takes the view that it is essential for financial stability to have in place insolvency arrangements for investment firms, as well as for deposit-taking banks, to ensure that an investment firm can be resolved in an orderly manner. The failure of Lehman Brothers (Lehmans) and more than 240 entities trading under its holding company, Lehman Brothers Holding Inc, in September 2008 posed serious challenges for insolvency regimes the world over."

(Special administration regime for investment firms, para 1.2, p 3).

Longer than a piece of string

Representations by Roland Baker

General introduction

I have professional experience in accounting firms that have acted for clients in tax and personal finance and for major financial institutions. I have dealt extensively in the past with tax legislation. I am an active shareholder in 2 major London-listed insurance companies in whose corporate governance I have taken an active interest. One of them lost substantial sums both in the collapse of Lehman Bros and AIG the American "monoline" insurer specialising in credit risk analysis and insurance using derivative instruments on a large scale. I am a member of 2 building societies in one of which I have taken an active interest. It has borne a large, totally unjustified, charge levied by the FSCS to cover the losses in the banking system that ensued from the Lehman and AIG failures and my savings returns have suffered accordingly. I make these representations as a member of the public at my own expense. I have not been paid to make them by any party and I do not make them on behalf of anyone other than myself. In these representations, page and paragraph references are to the Special Administration consultative document issued by HM Treasury in September 2010 unless otherwise stated.

Legislative objectives

The draft regulations set out from page 39 to the end of the consultative document have their object in the quotation on the front page of these representations. They supplement a wide range of existing insolvency and banking legislation. In view of the controversy about Insolvency Practitioners raised in the BBC Radio 4 programme "File on 4", broadcast on 12 and 17 October 2010, it should not be assumed that merely providing a special legislative regime will result in an orderly winding up. In practice only a small number of the largest insolvency firms will have teams capable of dealing with such complex financial arrangements so the competitiveness of the market in costs, practice and skills will inevitably be constrained. Ernst and Young, one such firm, was criticised in the BBC broadcast for failing to realise maximum value for the creditors and for conflict of interest.

Structure of the draft regulations

I refer to my experience in interpreting Income Tax legislation. There is a clear distinction between terms of art and terms construed according to ordinary language. These principles of interpretation hold good to this day. Law is interpreted by its inherent specialist definitions or the dictionary meaning of words. Given the likely complexity of unravelling a special administration, I am not sure I accept that, per para 1.11, frequent applications to the court can be avoided.

A "business day" is defined as a term of art in draft regulation 12(6) which brings forward a definition from S 251 of the Insolvency Act 1986. Surely a business day is relevant for all the purposes of the draft regulations and should be mentioned in draft regulation 2, Interpretation. It would be sensible if an Insolvency Practitioner were an officer of the court for all the purposes of the draft regulations and not merely defined as such in regulation 15 particularly as the earlier regulation 7 deals with the powers of the court. In fact, all that occurred with regard to Lehman Brothers took place in the "lost week-end" of British banking and the actions required took place on non-business days to ensure that, on the next available business day, the cash dispensers would be able to supply liquid funds.

Regulation 3 provides the overview, after the citation and commencement rather than before it. Why does it not also precede the definitions?

In regulation 2, the phrase "return of client assets" refers to the position of the investment bank as bailee in holding the assets to the order of the client in that capacity or by some other means. Presumably this should be any other means. The law of bailment already has an uneasy relationship with the obligations of the law of contract.

Presumably bailment in this context is not to be confused with bail-in creditor recapitalisation as in para 1.15. The terms bailor and bailee are not defined for the purposes of the regulations opening up their interpretation to a large body of common law in the event of dispute.

Once the regulations have been approved by the House of Commons they will be open to the interpretation of the Courts. Given the complexity of the law relating to insolvency and the additional regulations for special administration this will involve large commercial chambers of barristers instructed by magic circle legal firms. It is hard to see how this will expeditiously and cost-effectively recover the claims of depositors and creditors.

I will deal below with the specific questions you have asked.

Q 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?

It would be impossible to draft any regulation to cover all conceivable circumstances. Of the known methods of holding client money, the biggest risks are to regulatory arbitrage as with the Icelandic Banks and not what "client money" actually means.

CASS http://fsahandbook.info/FSA/html/handbook/CASS/7/2, the FSA Client Assets Sourcebook, refers to what is not client money at CASS 7.2. The "client money" link opens http://fsahandbook.info/FSA/glossary-html/handbook/Glossary/C?definition=G160 which is the glossary definition in the Full Handbook of the FSA not CASS.

In the above glossary definition, mortgage intermediaries (para 2) are mentioned alongside investment banks (para 2A) but so are home finance intermediaries (para 3). As per para 2.9 on page 8 of the SAR consultative document, would the Government also like to make it clear that home finance intermediaries will not be subject to SAR?

Normally deeds of trust are meant to keep client money separate from the business of the firm so that, should the firm encounter liquidity and solvency problems, client money cannot be used to bail it out as happened at Farepak to take a simple example. Would the recovery of client money, however defined, proceed vis a vis the firm or trustees of client accounts? How would client money defined in CASS interface with client money defined in any deed of trust if different and what would be the duty of the trustees? What would be more useful would be improved custodianship arrangements to match purported investments to the actual facts. Every investment bank should have a Chief Custodianship Officer alongside but separate from the Finance Director and Chief Information Officer.

Q 2 Do you agree with the proposals for initiation of the SAR, as set out above and in draft regulations 4 to 8?

In draft regulation 8, the 4 conditions from draft regulations 8(5)-8(8) inclusive should be brought into regulation 8(5) as conditions a, b, c and d. Draft regulations 8(9), 8(10) and 8(11) should be re-numbered accordingly. Draft regulations 8(1-4 inclusive) should refer to the conditions in regulation 5 so there is no doubt about which conditions apply.

In draft regulation 8(6), condition 2, compliance with condition 1 is required but condition 1 in draft regulation 8(5) does not impose a compliance requirement. What seems to be required is a copy of the notice mentioned in condition 1.

In condition 3 in draft regulation 8(7)(a) it might be wise to specify that the notice is received by the FSA and that the notice is the notice mentioned in condition 1.

Is it clear whether, in draft regulation 8(11), the 4 items in 8(11 a-d inclusive) are alternatives or whether more than one is necessary? It might be better to say that "preliminary steps taken in respect of an insolvency procedure" means one of the following and group them, specifying steps that must both be taken. For example, one of the following might be that both an application for an administration order and a petition for winding up have been presented and state to whom they should have been presented.

There is no reference to obtaining the consent of the Bank of England which might be necessary as institutions likely to be subject to this regime will be of systemic importance.

Q 3 Should the scope of Objective 1 be amended in either of the ways as set out in paragraph 2.23?

CASS http://fsahandbook.info/FSA/html/handbook/CASS/7/4 requires that client money be segregated. Para 2.23 of the SAR consultative document seeks to make provision against the possibility that it has not been segregated and mentions the possibility of litigation. If a client lost money because segregation did not take place, that litigation would be against the FSA for not enforcing the rules. Note my remarks in response to Question 1 on custodianship and CASS http://fsahandbook.info/FSA/html/handbook/CASS/6/1.

Before considering whether to split Objective 1 with regard to non-segregation of client assets, perhaps Draft regulation 10 could be tested against the possibility that it might be litigated and interpreted by a court. What sanction exists against the administrator, who is an officer of the court, if the objectives are not met? Draft regulation 10(2) declares the order of the objectives not to be significant so why put them in an order? Surely the special administration objectives do not have to be achieved in the order set out in draft regulation 10(1) but they have to be achieved. The regulation should declare the order in which they are achieved to be a matter for the administrator to determine subject to draft regulation 16 and then specify that the administrator must carry out draft regulation 10(2 a & b).

I am not sure that objective 1 should be split until it is clear who has the duty to ensure that segregation of client assets has taken place. It is a regulatory requirement that client assets should be segregated so is it the duty of the regulator to ensure that they are? Or should it be the duty of a Chief Custodianship Officer at the institution which hands over the client assets to ensure that a receipt is given saying assets have been segregated? Or should it be the duty of the receiving institution to segregate them and compensate through insurance at their expense for any default? Litigation is unlikely to prove fruitful where a firm is insolvent, client assets have not been segregated and there is no form of indemnity. Lehman Brothers and even Presbyterian Mutual are examples of what ultimately happens. The Government prints the money to cover it.

Draft regulation 10(1)(a) imposes the objective of returning client assets as soon as reasonably practicable. Expediting the return of non-segregated client assets is not achieved by returning the segregated assets more quickly. If the obligation is split, the non-segregated client assets could be disadvantaged and more litigation, rather than less, would result from trying to establish fault in the non-segregation by clients/creditors seeking to advance claims to speedier payment. So the objective should not be split.

Q 4 Do you agree with the bar dates proposal as set out in draft regulation 11?

There is no objection to reasonable bar dates by which claims in a special administration must be submitted. Those claims should mostly be made by professional parties who would have ready knowledge of what their claim should be.

In the relatively rare event that an unsophisticated member of the public has to make a direct claim, the administrator should be obliged to assist in the preparation and submission of the correct claim.

Q 5 Do you agree with the allocation of shortfalls proposal as set out in draft regulation 12?

Doubtless the allocation of shortfalls follows their calculation by reference to the value of client assets. I note that para 2.32 on page 12 of the SAR consultative document mentions the Financial Times as a reliable source of mid market prices. HMRC, which also has an interest in valuing the trading activities of a firm in administration, has traditionally used quarter up prices which are published in the Stock Exchange Daily Official List by the London Stock Exchange under the aegis of the UK Listing Authority which is the responsibility of the FSA. So the SEDOL quarter up prices ought to form the basis of calculation. Draft regulation 12(6)(a) might be amended accordingly and refer to the SEDOL or equivalent source for which the Financial Times might be one – among many. http://www.londonstockexchange.com/products-and-services/reference-data/valuation-data/validation-data.htm

Beyond that, as client money is provided for separately in CASS, there is no practical alternative to apportioning the shortfall pro-rata to all the interests. It will be interesting to see, once these regulations are in force, whether clients will begin to insist on designated client asset accounts and omnibus accounts will fall out of favour. It is no more onerous for an investment bank to hold the designated accounts and keep records for each client on that account than to make separate calculations and aggregate the results. The clients will have to assess whether any loss of market leverage from dealing stock in smaller quantities is a price worth paying for the additional security.

Q 6 Do you agree with Objective 2 as set out in draft regulation 13?

Draft regulation 13 sets out only what the administrator would in any event have to do to resolve the affairs of an insolvent investment bank. There is a requirement to co-operate with a market infrastructure body. Draft regulation 2 includes an overseas clearing house or overseas investment exchange in this definition. Draft regulation 13(2) permits the administrator to refuse a request that might reduce asset values in the administration. But there appears to be no right to refuse a request from an overseas market infrastructure body that would place the administrator in conflict with a request from the authorities as defined in draft regulation 2 which are the FSA, The Treasury and the Bank of England.

Q 7 Do you agree with Objective 3 as set out in draft regulation 10?

Draft regulation 10(1)(c)(i) sets out an objective to rescue the bank as a going concern. It would not be for the administrator to rescue the bank by providing the means to do so. It would be for the administrator to find a third party to take over the running of the investment bank as a going concern, transfer the whole or part of its business as a going concern, or find a party to inject new capital to underpin its liabilities and provide working finance. The Banking Act 2009, s 137(1)(a) refers to support for a commercial purchaser in setting out a similar objective but, in contrast to these draft regulations, specifies that providing support for a commercial purchaser takes precedence over “normal” administration. It seems to be intended to import into the special administration of an investment bank parallel principles to those applying in bank administration per para 2.1 on page 7 of the SAR consultative document.

Might objective 3 not be better expressed? Draft regulation 9 extensively imports the Banking Act 2009 via draft Schedule 2 of the regulations where the investment bank is a deposit taking bank. So consistency of approach and wording are important.

Should objective 3 be to facilitate the continuation of the investment bank as a going concern (rather than rescue it) or, if that is not possible, wind it up in the best interests of the creditors? If, in contrast, to the Banking Act 2009, continuation as going concern is unlikely as per paras 2.20 on page 10 and 2.39 on page 13 of the SAR consultative document, perhaps objective 3 should be primarily to wind it up in the best interests of the creditors unless, in exceptional circumstances, a purchaser can be found.

These remarks are, in any event, subject to comments on Question 8 below as it is proposed to give the FSA power to direct the administrator in prioritising the objectives in draft regulation 10.

Q 8 Do you agree with giving the FSA a power of direction as set out above and in draft regulations 16 to 20?

Para 2.40 of the SAR consultative document on page 13 is of some concern. It is proposed that the FSA will consult the Bank of England and the Treasury before issuing an order to prioritise SAR objectives in draft regulation 10 pursuant to draft regulations 16 to 20. Institutionally that is entirely correct. It gives me no comfort to note however that one likely source of advice from the Bank of England, now responsible for macro prudential regulation of the banking system, will be the Deputy Governor of the Bank of England who was head of wholesale markets at the FSA when Northern Rock fell into financial difficulties and subsequently became Chief Executive of the FSA. Nor am I assuaged in my view by resounding applause from the banking industry for that appointment.

The administrator is placed in an invidious position by the control mechanism. It is not proposed to make regulations dispensing with the need for creditors' approval of the administrator's plan to comply with an FSA prioritisation order. Consent to proceeding against the opposition of creditors would have to be obtained from the court which will take time - depending on how many creditors there are. The legal costs are likely to be substantial. According to para 1.11 on pages 4 and 5 of the SAR consultative document:

> "There are two main aims for the SAR. The first aim is to provide administrators with clarity and direction to conduct the administration, without the need to make frequent applications to the court for directions. The adjustments to current insolvency law should make the process less expensive and less disruptive for all concerned. The second aim is to give clients and counterparties greater confidence in the administration process and therefore reduce the impacts of an investment firm insolvency on the stability of the UK's financial systems."

The FSA direction is designed to promote the stability of the financial system or public confidence in it and the financial markets so quick action is paramount. Frequent applications to the court may occur if the FSA has to give a direction because that is likely to result in significant loss to creditors. The financial system would only be threatened if the institution in administration is systemically important and hopelessly indebted. Creditors would be in breach of their duty to their own institutions if they did not pursue every avenue of recovering the maximum amount. They may force the administrator to court by refusing to agree the liquidation plan, FSA directions or any amendment.

Draft regulation 15 applies Table 1 and imports Schedule B1 insolvency law. Table 1 states that, in applying para 55, regarding failure to approve the administrator's proposals, a court must have regard to the special administration objectives. The objectives are procedural not a public interest or confidence test. The court's order should also have regard to the public confidence test for the direction under draft regulation 16(2a & b).

Draft regulation 18 permits the administrator to propose amending the FSA direction only if the revision is substantial. What degree of materiality is implied by substantial and is it a quantitative or qualitative test? The administrator is required to agree the amendment with the FSA but draft regulation 18(2) does not specify what happens if they cannot agree.

I note from para 2.50 on page 16 of the SAR consultative document that draft regulation 15 modifies Sch B1 para 91 so the FSA can appoint a replacement administrator. Is this the intended remedy? Or will it have to be resolved in court? Will the approval of creditors have to be obtained and the court asked for a dispensation if they do not agree?

The Bank of England and the Treasury are to be consulted by the FSA before a direction is given under draft regulation 16(4) but no provision is made if they cannot agree. There is no provision for the administrator to consult the Treasury and the Bank of England before seeking an amendment under draft regulation 18. In draft regulation 16(4) the FSA is obliged to consult the Treasury and the Bank of England before a direction is given but not before it is amended. The FSA's power under draft regulation 16 is to order a priority in which the special administration objectives under draft regulation 11 should be addressed and takes the place of the administrator's discretion in draft regulation 10(2 a & b).

In view of the public confidence and interest test in draft regulation 16 (2 a & b) for varying the administrator's discretion, it might be better for the Secretary of State to have the power to order the priority in which the objectives are addressed.

Q 9 Do you agree that the continuity of service provisions should be extended as set out above and in draft regulation 14?

It seems reasonable that key suppliers of services essential to the administration should not use their commercial arrangements to obtain preferential payment as creditors by withdrawing supplies for debts outstanding when the administration commenced. Draft regulation 14(2)(a)(i) obliges the administrator to pay for the services supplied after administration commenced within 28 days. The commencement date for calculating 28 days is not specified. Nor is the administrator provided with redress if the services were not satisfactory so perhaps a qualification should be added to make it clear.

Draft regulation 14(5) defines a supply which covers making the service available but may not impose an obligation to maintain it at a particular level. Broadband operates at an agreed level of bandwidth sufficient to cope with the traffic. It is possible to prioritise competing demands on bandwidth so as to advantage one customer or one function over another and to configure broadband to work at less than the available DSL connection rate. The provision of a DNS server for electronic mail may not provide adequate storage and the WAN interface may require the supplier to pay a third party who has no privity of contract with the administrator. A service level agreement should be required.

Q 10 Do you agree with the modifications to Schedule B1 administration as set out above and in draft regulation 15?

Per my response to question 8, there is potential for the modification of Sch B1 para 91 to be abused as the FSA could appoint a replacement administrator in the event, for example, of failure to agree on an amendment to a direction under draft regulation 16.

In para 2.50 on pages 15 and 16 of the SAR consultative document and in para 3.9 on page 23, I note that the liquidator's costs in returning client assets are chargeable to those assets. This is reflected in the modification to para 99 per Table 1 pursuant to draft regulation 15. What control will there be on the costs? Might it not be better to charge those costs to public funds so they can be scrutinised by Parliament and the Treasury and Public Accounts Select Committees?

Client assets are likely to be held ultimately for investors who may claim on the FSCS. The liquidator's costs charged to those assets can only reduce them and increase any amount the FSCS may have to pay. That is not a victimless crime. The FSCS is financed by a levy on institutions that have been prudent and has already resulted in injustice.

The Nationwide Building Society was the second largest contributor to the FSCS following the collapse of Bradford & Bingley and Alliance & Leicester. Why can the cost of returning client assets not be charged to the administration as a whole and be borne first by the general unsecured creditors?

Q 11 Do you agree with the interaction of the SAR and the Bank Insolvency Procedure as set out above and in Schedule 1 to the draft regulations?

What is the practical effect of inserting Objective A in draft regulation 9, Schedule 1, by Schedule 1 draft regulation 4? It seems that the administrator will have a primary duty to the return of customer deposits whatever priority order is agreed or directed for the special administration objectives. The administrator cannot do everything at once. The administrator's requirement for skilled staff is multiplied by having to pursue objective A at the same time as immediately commencing the special administration objectives under draft regulation 10. This can only increase the overall costs and so reduce the assets ultimately available for distribution as the administrator's costs are a charge on them. See also my response to question 10 regarding the charge on the FSCS.

The "Objective A committee" per para 2.57 on page 17 of the SAR consultative document is said to include the FSA, the Bank of England and the FSCS. The Banking Act 2009, s 100(2), modified by Schedule 1, draft regulation 6, refers to the liquidation committee as consisting initially of these three parties. Is it intended to limit the "Objective A Committee" only to these parties? Banking Act 2009 s 100(6 & 7) are ignored so I assume this is the intention but the word "initially" is not specifically deleted from Banking Act 2009 s 100(2).

The FSCS as an unsecured creditor will sit on the creditor's committee. It will, presumably owe its duty to those institutions that have been prudent with their affairs upon whom will devolve the FSCS levy for any shortfall in customer deposits. Will it have no particular responsibility to limit the costs of the liquidation? Should not a duty of minimising its ultimate levy be imposed on the FSCS in Schedule 1, draft regulation 5(2)? The depositors and the public purse should not be disadvantaged for the benefit of creditors as a whole. Nor should the liquidator feel that unconstrained costs can escape effective challenge.

Q 12 Do you agree with the interaction of the SAR and the Bank Administration Procedure as set out above and in Schedule 2 to the draft regulations?

The special administrator can operate in three legislative frameworks. First, ordinary special administration of an investment bank with no deposit-taking role. Second, special administration (bank insolvency). Third, special administration (bank administration). The second and third frameworks are for banks with mixed investment banking and deposit-taking roles. The first framework has objectives 1, 2 and 3. Both the second and third frameworks have Objective A. Perhaps they should be A1 and A2. Special administrators could be forgiven for becoming confused about their priorities. Similar comments to those under question 11 apply to staffing a special administrator's functions to pursue multiple and potentially conflicting objectives simultaneously.

Q 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?

Given difficulties in persuading senior bank directors to accept their responsibility for the credit and liquidity crises that beset the UK and other major world economies in 2008, legislation should be brought forward to leave banks in no doubt where they stand. Clear responsibilities should be placed on them to maintain operational reserves as part of their business risk management and continuity plans and to protect staff and suppliers.

Para 2.65 on page 18 of the SAR consultative document refers to staff incentive payments vested with the firm or otherwise needed to motivate staff to perform effectively in the administration. A strict limit should be imposed by law on the amount of any incentive vested with the firm that can be protected. No bonuses should be paid until satisfactory performance is complete. Incentives should be reasonable in relation to the duties to which they relate. Formal legislative necessity is proven by the unwillingness of the banking industry to match rewards to sustainable long-term performance notwithstanding the FSA's guidance on financial sector remuneration packages.

The main priority is to ensure that suppliers are fairly treated as they also have completely innocent employees to pay. The operational reserve should not reward people who contributed to the bank insolvency at the expense of the public or suppliers.

The operational reserve requirement should furthermore add to existing pensions legislation and proposals to tighten solvency requirements by monitoring any pension scheme deficit. Banks should be required to contribute additionally to an insurance scheme, or have their Pension Protection Fund risk rating increased, so their contribution reflects the risk of a major bank insolvency to pension benefits accrued by the staff. The directors should not benefit from such protection and they should be excluded from existing pensions law that secures past accruals of defined benefits so their benefits can be reduced if a bank becomes insolvent with a large deficit on the pension scheme. Funds released by these measures should be used primarily to return client money.

The Government should legislate because the whole purpose of the special administration regime is to deal with a major threat to the banking system. A risk to business continuity from a special administration is one that affects the whole economy. The Government should not wait until another insolvency has happened before it takes action. It is regrettable that legislation has not been brought forward with these draft regulations.

General Conclusions

Legislating for the chance that an investment bank will go into special administration constitutes reasonable risk management by a Government with a duty to the country but it is not as good as preventing the insolvency by enforcing financial services regulations and improving the skills and ethics with which all banking is conducted.

Some regulations provide for agreement between the tri-partite regulators but make no reference to what happens if agreement cannot be reached. The power of the FSA to replace an administrator is capable of being abused.

A priority direction can be made by the FSA for the special administration by agreement with the Bank of England and the Treasury. There is no provision for the FSA or the Special Administrator to consult the latter parties about, or seek their agreement to, an amendment. No provision exists to contain the Special Administrator's costs or subject them to government challenge or public scrutiny. The costs are paid out of funds that ought to be available to clients and creditors and may increase the FSCS levy.

The terms of art by regulation should be considered and taken into the general definitions as far as possible. It is a fundamental precept that the Special Administrator is an officer of the Court and the duty to the court should be specified to avoid conflict with the duty to the clients, the Government, the tri-partite system, the creditors and the possible continuation of the business as a going concern with new capital or a third-party purchaser. Nor is there any clear sanction in the event of failure to achieve the special administration objectives.

In concluding my representations, I assume the Government shares my devout hope that these regulations will go before Parliament never to be used until they form a bonfire of red-tape in some years' time. Prevention is better than cure.