Review of the Investment Bank Special Administration Regulations 2011:

by Peter Bloxham

April 2013

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Presented to Parliament pursuant to section 236 of the Banking Act 2009

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This publication is also available on http://www.official-documents.gov.uk/

ISBN: 978-1-909096-64-6
PU1453

Printed on paper containing 75% recycled fibre content minimum

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Foreword

The Special Administration Regime (SAR) was created in 2011 to offer a modified insolvency procedure for investment firms, in the light of the unfolding experience of the Lehman administration. The failure of Lehman has tested, and indeed continues to test, the capability of the UK's insolvency framework to deal with the failure of a large, modern investment firm in all its international and operational complexity.

The SAR amended the UK's insolvency framework as it applies to investment firms by allowing and requiring the administrator of a failed firm to prioritise the return of client assets held by that firm and by providing mechanisms designed to facilitate the prompt return of those assets.

At the time of writing, three firms have entered the SAR in the two years it has been in force, by far the largest of which is MF Global. None of these insolvency procedures is yet complete. Some clients have been frustrated by the slow return of client assets under the SAR. This may well stem in part from a misunderstanding of both what the SAR was designed to do and what it is capable of delivering. It does not offer a magic bullet, nor is it a resolution, or a special compensation, tool.

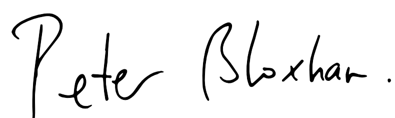
In creating powers for the government to make regulations to deliver this special administration regime, Parliament required that the Treasury hold an independent review of the SAR within two years of it coming into force. This is that review, which I have completed within the statutory deadline.

In asking me to look at the SAR, and how well it is meeting the aims set out for the SAR, the Treasury also asked that I take a broader look at whether there is more that could or should be done – not just in legislation, but also in regulation and in market practice – to speed up the return of client assets[1] in the event of the failure of an investment firm. I have started that process.

To this end, they asked me to work closely with the FSA as it undertakes its own review of its client asset and client money rules.

In addition to making a number of immediate recommendations, I also set out further areas that I would like to review in more depth, as part of a second phase of my work. This second phase will co-ordinate with the FSA's review.

I am grateful to those who have made the time to respond to my call for evidence and to meet with me since my appointment. This has greatly assisted me in understanding the wide range of issues associated with this review.



Peter Bloxham

7 February 2013

[1] 'Client assets' is taken to mean client money and custody assets, ie financial instruments, held and received by a firm in connection with applicable regulated activity.

Executive summary

Because of the time available since I commenced work, this should be regarded as an interim report. I have only been able to carry out a limited consultation.

There are other reasons why it would not be appropriate to issue definitive recommendations at this stage:

- Client money is of course a key component of client assets and the FSA has yet to announce the final outcome of its review of the client assets regime; any changes to the SAR regime need to move in step with reforms of the client assets regime; and
- None of the three Special Administrations to date has yet been completed; it is not possible to make a concluded judgment on the SAR's operation, and there may yet be further lessons to learn from them.

Despite these points, there may be merit in implementing some of the behavioural recommendations as soon as possible.

In summary, the provisional conclusions of the review are that:

- The Banking Act 2009 sets out a number of broad and ambitious objectives for the SAR regime, discussed in detail below. These include objectives specific to a particular insolvency, such as "facilitating return of client assets" and "protecting creditors' rights", as well as more generalised and market focussed aspirations, notably that it should "maximise the efficiency and effectiveness of the financial services industry in the United Kingdom"; it must be questionable whether any variant of insolvency law could be expected comprehensively to achieve all those objectives;
- The SAR can be said to have made progress towards the achievement of the more focussed of those objectives, and each of the three cases to date has benefitted to different degrees from the operation of the SAR (compared to how they might have been expected to proceed in its absence);
- There is a measure of disappointment with the SAR, but it may be that this is at least in part because there was an undue weight of expectation placed on it;
- The SAR regime should be retained;
- There are some enhancements which could usefully be made to the SAR by way of amendments or supplemental provisions (see paragraphs 5.1 – 5.18);
- There are a number of non legislative actions, of a behavioural or operational nature, on the part of firms, their clients and regulators in "going concern" mode, which might reduce the risk of delays in the return of client assets in future SAR cases. In particular, it seems clear that quality and accuracy of record keeping and clarity as to entitlements (both of clients *vis a vis* the failed firm and of the failed firm *vis a vis* any third parties who may in fact be holding the underlying assets) are two of the most important factors in determining speed of return of client assets (see paragraphs 5.31 – 5.38);

- In cases involving, broadly speaking, retail clients, the FSCS plays an important role and there are a number of specific recommendations for consideration as to how it might be possible to streamline those processes and therefore accelerate the payment of compensation to eligible clients of failed investment firms (see paragraphs 5.39 – 5.45). These seek to build on the recent changes to the FSA's Compensation Rulebook (COMP);
- It is desirable to continue to monitor:
  - the progress of the existing SAR cases;
  - developments in the Lehman administration; and
  - new developments such as the introduction of EMIR and the porting obligations which that regime introduces;

  in order proactively to keep under review whether further legislative or behavioural changes should be considered to enhance the operation of the SAR regime.

The recently closed FSA consultation on its CASS rules (CP 12/22) invited views on the desirability, in order to facilitate both porting under EMIR and rapid return of client assets of a failed firm, of permitting client money sub pools. I have been able to review the wide range of views expressed as part of this consultation exercise. Should the SAR review be extended, I would propose to engage with the FSA and market participants to ensure that adequate consideration is given to the consequential changes which may need to be made to existing SAR procedures to take account of the possibility of sub pools (if this is permitted) and to remove undue obstacles to the return of client monies held in sub pools.

My terms of reference were to review the SAR as it was created within the scope of the Banking Act 2009 and to consider whether, and to what extent, it has achieved the objectives set out in that Act. As such, it is a variant of insolvency law, designed to offer an administration procedure which has as one of its specific priorities the identification and return of client assets. It is not a compensation regime (except to the extent that the FSCS protection may be triggered). It is beyond the scope of my review to consider whether, as a matter of wider policy, there should be a move to replace the insolvency based SAR regime with one which provides a greater degree of comprehensive protection for client assets when an investment firm fails.

I consider that this SAR review exercise should continue. If the Government accepts this recommendation, I hope that interested parties will provide comments on the provisional recommendations and suggestions for further work in the Report. In addition, I have included some suggestions for a further work plan.

0 Summary of Recommendations

The main recommendations of this initial report are set out below. Work to develop these further will continue as part of Phase 2.

- The SAR should be retained.
- A mechanism should be introduced to facilitate the rapid transfer of customer relationships and positions, where feasible.
- The statutory objective in relation to client assets should be clarified by extending from "return" of client assets to "return or transfer".
- There are a number of aspects in which the existing provisions for information sharing and co-operation could usefully be extended.
- The Bar Date mechanism should be extended to include client monies.
- The administrator should be permitted to make distributions of client assets during the period after the Bar Date process has commenced.
- The SAR should clarify the clients' rights to income, interest and distributions in respect of client assets, and interest on client monies, arising during the period of administration.
- The administrator should be empowered to make full use of communication with clients by electronic means.
- Further consideration should be given to granting limited immunity for administrators, see paragraphs 5.20 – 5.29.
- A number of **good practice** recommendations also arise:
  - Firms may need to improve the quality of their record keeping and reconciliation.
  - Firms should ensure that clients (especially retail clients) are able readily to understand the contents of client statements.
  - The FSA should ensure full understanding of the Client Money and Asset Rules.
  - The FSA should require firms to ensure that intra-group relationships relevant to the holding of client assets are clear and transparent to clients.
  - FSA, FSCS and HMRC should ensure that the existing gateways for exchange of information are optimal.
  - FSA should continue to improve CASS resolution packs in the light of the experience of the SAR administrations.

- A number of recommendations apply to the work of the **FSCS**:
  - FSCS to work with investment firms to make clear to clients which clients and products fall within the scope of the FSCS.
  - Consideration should be given to amending the current FSCS product perimeters, though this may be problematic.
  - The potential for using the FSCS as a mechanism to facilitate transfers should be explored.
  - More should be done to ensure that the FSCS has rapid access to the information it needs to facilitate a payout.

0 Explanation of Terms

For clarity I use in this report the same terminology as in Banking Act 2009 and the Investment Bank Special Administration Regulations 2011.

Bar Date

The SAR *bar date mechanism* refers to the provision in the SAR for an administrator to set for the purposes of a planned distribution a cut-off date for client, affiliate and third party claims to client assets through the imposition of a bar date.

EMIR

The *European Market Infrastructure Regulation* (EMIR) is a European Union regulation on derivatives, central counterparties (CCPs) and trade repositories. It introduces new requirements to improve transparency and reduce the risks associated with the derivatives market. EMIR also establishes common organisational, conduct of business and prudential standards for CCPs and trade repositories. EMIR entered into force on 16 August 2012, but most provisions only apply after technical standards enter into force.

EMIR porting provisions

EMIR contains *porting provisions*, under which, in the event of the clearing member's default, a CCP must attempt to 'port' any client positions and associated margin held by a CCP to another, solvent clearing member (a backup clearing member). Where porting fails for any reason, any balance owed by the CCP shall be returned directly to clients or to the clearing member for the account of its clients.

Investment bank

Although the term used to describe firms which are subject to the SAR is "investment bank", the SAR regime covers entities which are not banks in the sense of being deposit takers.

Preference

The word *preference* means that the client or creditor would have a higher ranking legal right (compared to other creditors of the failed firm) to receive payment or distribution in respect of his claims on the failed firm.

Prioritise

This report uses the term *prioritise* to denote that there is a legal requirement to attend to that task at an early stage in the administration.

SAR – Special Administration Regime

The *Special Administration Regime (SAR)* is set out in the Investment Bank Special Administration Regulations 2011 (SI 2011/245).

SIPA

The *Securities Investor Protection Act 1970* provides for protection for customers of registered brokers and dealers and members of national securities exchanges in the United States of America, partly through the establishment of compensation fund.

SRR – Special Resolution Regime

The *Special Resolution Regime (SRR)*, established in the Banking Act 2009, is the UK's statutory toolkit for resolving failing banks and building societies where their failure would pose a threat to the stability of the UK's financial system. The Financial Services Act 2012 extends the scope of the SRR to investment firms, UK recognised clearing houses and banking group companies.

1 Introduction

1.1 The Investment Bank Special Administration Regulations 2011 came into force on 8 February 2011.

1.2 Section 236 of the Banking Act 2009 requires the Treasury to arrange for a review of the effect of those regulations to be completed within two years of the date on which those regulations came into force. This is the report of that review.

1.3 This review serves two purposes. It fulfils the statutory objective to consider how far the regulations are achieving the objectives specified for them and, in particular, to consider whether the regulations should continue to have effect. But it also gives the opportunity – which the Treasury has asked me to pursue – to take a broader look at the landscape in which the SAR works and to assess any changes that should sensibly be made, either to the regulations themselves, or to broader legislation, regulation and practice.

1.4 The full terms of reference of the review are at Annex A. The review is focussed on the SAR in its present form as a particular variant of insolvency law and on any possible amendments to it. It does not extend to proposing wider policy or legislative changes, such as creating a standalone regime, outside conventional insolvency law, for the return of client assets in the event of failure of an investment bank, although I will indicate areas which the Treasury may wish to consider further.

1.5 In the time available I have focused primarily on the statutory requirement of the review, but I have also identified a number of wider recommendations and further lines of inquiry that I intend to pursue in the second stage of my review.

1.6 It is worth noting that the SAR is not, and was never intended to be, a resolution regime for systemic investment firms, i.e. those whose failure into insolvency would bring an unacceptable risk to the viability of the wider financial system. Since the creation of the SAR the government has, through the Financial Services Act 2012, created a Special Resolution Regime (SRR) for investment firms. This SRR is closely modelled on the equivalent regime for banks, and creates a series of stabilisation powers that allow:

1. the Bank of England to transfer the shares or some or all of a business of a bank to a commercial purchaser;
2. the Bank to transfer some or all of the business of a bank to a "bridge bank" wholly owned by the Bank; and
3. the Treasury to transfer the securities of a bank into temporary public ownership.

1.7 The Recovery and Resolution Directive which is now being negotiated in Europe will bring a similar regime into being across Europe when it takes effect. The UK will need to transpose into UK law any provisions not already in place as part of the SRR.

1.8 There are a number of underlying factors to be taken into account as part of this review:

- neither the Lehman administration nor MF Global special administrations have yet been completed, with a number of legal judgements yet likely to add to case law and our understanding of the issues raised by the failures;

- whilst there is a perception of comparative slowness in the UK in returning client assets, the end result, in terms of the amounts returned, may yet be more beneficial to clients than is the case elsewhere; and
- the impact in any future SAR cases of the "porting" provisions of EMIR.

1.9 In addition, running in parallel to my review, the FSA has been engaged, since the middle of 2012, in a potentially wide ranging review of its client assets regime. This was partly occasioned by the need to make some changes to the Client Money rules with a view to ensuring the feasibility of porting of client positions under EMIR. However the FSA took the opportunity to canvass views on a wider reform of its current client assets regime. The FSA is currently considering its response to the latest phase of the consultation exercise and plans to issue its final proposals in this regard later this year.

1.10 An effective SAR regime calls, among other things, for a holistic approach between regulation in going concern mode and the operation of the SAR in gone concern mode. Sensibly, therefore, my Terms of Reference require me to ensure that I deliver my review in co-ordination with the FSA's review of its own client assets regime and engage fully with that review.

1.11 I am grateful to the FSA for their assistance in enabling me to familiarise myself with issues involved in the review of SAR. A good example is the insight they have given me into the debate – sparked by their consultation on their client assets regime – about the relative merits of accuracy of return of client assets and of speed of return of client assets, including as to whether these should be seen as mutually incompatible. There is a view that the SAR regime (and English insolvency processes generally) privilege accuracy at the expense of speed, whereas some clients might prefer a more rapid return even if it may imply a limited reduction in the amount of assets returned. I allude to this debate in my recommendations.

1.12 I propose to work alongside the FSA in the second phase of my review, so as to ensure that my final recommendations, insofar as they relate to client monies and assets, will operate consistently and effectively with any reform of the CASS rules.

1.13 It is within this context that my review takes place.

2 Investment Bank Special Administration Regulations 2011

2.1 The SAR was developed to increase the confidence of market participants in the effectiveness of the UK's insolvency regime as it applies to investment banks. It came in response to widespread dismay at the slow return of client assets in the LBIE administration.

2.2 The primary legislation enabling the creation of the SAR was the Banking Act 2009. Box 2.A sets out the series of statutory objectives contained in the Banking Act for the SAR:

Box 2.A: Statutory objectives for the SAR

a. identifying, protecting, and facilitating the return of, client assets;

b. protecting creditors' rights;

c. ensuring certainty for investment banks, creditors, clients, liquidators and administrators;

d. minimising the disruption of business and markets; and

e. maximising the efficiency and effectiveness of the financial services industry in the United Kingdom.

Source: Banking Act 2009

2.3 After a period of consultation with industry and insolvency practitioners, the SAR was then introduced in February 2011. The SAR translates the above statutory objectives into three special administration objectives which administrators have a duty to follow, set out in Box 2.B.

Box 2.B: Special administration objectives of the SAR

- To ensure the return of client money or assets as soon as is reasonably practicable;
- To ensure timely engagement with market infrastructure bodies; and
- To rescue the investment bank as a going concern or wind it up in the best interests of creditors.

Source: Investment Banks Special Administration Regulations 2011

2.4 Through these administration objectives, the SAR regime therefore imposes on the administrator a number of specific prioritisations of tasks in the exercise of his functions, i.e. there is a legal requirement to attend to these tasks at an early stage in the administration. These include of course the return of client assets (Objective 1). However the regime does not create any preference, in terms of claims that a client may have on the insolvent estate (for example, if there is a shortfall in the client's assets), i.e. it does not give clients a higher ranking legal right (compared to other creditors of the failed firm) to receive payment or distribution in respect of his or her claims on the failed firm.

2.5 Given the lengthy consultation that took place, this must be taken to have been a deliberate policy decision when the SAR regime was created and, indeed, when the enabling provision in

the Banking Act was enacted. As set out above the aspirations under the Banking Act include both *identifying, protecting and facilitating the return of client assets* and *protecting creditors' rights*.

2.6 This means that the SAR regime was deliberately structured as a variant of the conventional administration process, rather than something entirely new. Indeed, in some respects, the modifications to general insolvency law introduced by the SAR regime are relatively modest. Once the three objectives and consequential provisions are set aside, a significant proportion of the provisions of the SAR are procedural in nature.

2.7 These modifications, notably in relation to the use of the Bar Date and to security of supply of key services, have been, or will be, valuable in the SAR cases to date. But, except where the SAR rules modify them, the normal principles and rules relating to administrations and the conduct of administrators apply. Consequently, it should not be expected that administrators will approach a SAR case in a manner radically different from another administration.

3 Task faced by an investment firm administrator

3.1 It is important to remember the context in which an investment firm SAR administrator operates.

3.2 A fundamental consequence of the SAR regime being a variant of insolvency law is the appointment of a new and independent person to take charge of the affairs of the failed firm. Whilst incumbent management, as well as specialist staff, may have a role in assisting the administrator, the policy decision that has been taken is that – as in all other insolvencies – the affairs of the failed firm should henceforth be managed by a person who, by definition, may have little or no familiarity with the detailed operations and systems of the firm or of some or all of the markets in which the failed firm has been operating, especially in cases where the failure occurs in a very short space of time. Inevitably this policy decision has costs, in terms of delays and real economic costs.

A firm that has failed

3.3 The administrator will be going into an investment firm that has, by definition, failed. No administration regime can by itself remedy the underlying problems that may have led to the failed firm going into SAR (or any alternative procedure) in the first place. It is worth bearing in mind that an administrator takes the failed firm as he finds it. Thus, if, for whatever reason, the firm's records are incomplete or not up to date, there is nothing a bespoke regime can do by itself to abolish the effects of the resulting complications and delays.

Inheriting a complex situation

3.4 The administrator will often inherit a deeply complex situation, with an investment firm and other market professionals typically often having many relationships in place and this being reflected in the underlying contractual and regulatory nexus. Particular aspects to note are:

- the sheer complexity of sophisticated contractual and transaction structures, often designed at a time when the insolvency of the financial services firm (as opposed to its counterparty) was assumed to be unthinkable;
- the scope, in the London marketplace and elsewhere, for parties to choose to adopt rehypothecation and "title transfer" structures which result in clients losing some of the protection around their assets in return for flexibility (or lower rates) in connection with funding and liquidity facilities;
- the use, by larger investment firms, of group members, possibly in other jurisdictions, with whom the client may or may not have a contractual relationship, to perform some of the services provided to the client;
- the possibility of subcustodian relationships, to which the counterparty and not the client is a party, in relation to the holding of the client's assets. These are often necessary in order to enable the parties to achieve their business objectives, but may:

a at the very least complicate the gathering of transparent information about the status of any individual customer's assets;

b introduce potentially conflicting terms; and

c create the complication of an overseas jurisdictional element;

- The multiplicity of parties, each with different record keeping systems, involved in the completion and clearance of securities and derivatives transactions.

3.5 It is bound to be a challenge (with ensuing delay) for an administrator, coming new to the failed firm, rapidly to familiarise himself with all these aspects of the failed firm's client asset relationships.

Group structures add further complexity

3.6 The task will be made still harder if the failed firm operates in a group structure, as will often be the case. A complication in any insolvency case (not just in the financial services sector) is the gulf between the tendency, in going concern mode, for groups of companies to operate in convenient economic units, ignoring strict legal structures, and the contrasting requirement for any insolvency officeholder to treat each individual legal entity as distinct, with its own pools of assets and liabilities.

3.7 Some typical problems which can arise in an ensuing insolvency include:

- The fact that it may not be immediately apparent who owns what or the legal or contractual basis on which Company A is doing acts for the account of company B;
- An administrator may be reliant on access to data or services provided historically by another company in the group over which he has no control;
- The administrator may have to contend with litigation brought by group companies or their own insolvency officeholders in relation to assets, including client assets, of the failed firm; and
- In extreme cases clients may not know exactly which group entity they were contracting with.

Need to determine FSCS protection

3.8 In the financial services sector, the involvement of the Financial Services Compensation Scheme in its important role of protecting certain consumers can bring further complication for the administrator. Initially after insolvency there will be an exercise to determine which clients are entitled to FSCS protection and in relation to which products. It will be necessary for information to be passed from the administrator to the FSCS, which then communicates with the eligible client. In the cases to date the FSCS has had to obtain the requisite signed application for compensation and an assignment of rights from the eligible client. The FSA's recent changes to its Compensation Sourcebook have begun to address the lessons learnt in the banking crisis and more recent failures.

Third party assets and incomplete transactions

3.9 Then, it is likely that some of the client assets and monies will be held by a third party, in UK or elsewhere. A practical precondition to returning the asset to the client is that the asset must have been returned to the administrator. The third party may not recognise that the assets in question are "pure" unmixed third party assets or may seek to assert claims on those assets, delaying release.

3.10 In relation to transactions which were incomplete or unsettled at the time of the appointment of administrators, there will be additional reconciliations with trade counterparties and/or market infrastructure bodies.

Steps that an administrator then needs to take

3.11 It may be worth summarising what steps are then needed before the administrator can distribute client assets under the SAR.

3.12 The following steps need to be followed, at the least:

1. The administrator needs to review the firm's client records in relation to client assets on a per client basis;
2. The administrator needs to identify which assets are in fact held by affiliates or third parties; reconcile the firm's records and the affiliate or third party's records; and recover those assets from the affiliate or third party;
3. The administrator needs to look at the aggregate asset holdings of the firm and ascertain if there are any shortfalls (compared to the firm's own records of clients assets) on an investment by investment basis; the administrator must then attribute that shortfall to an individual client, and where this is not possible determine which group of client claimants will incur this shortfall;
4. The administrator needs to check whether the failed firm has any claims over client assets in relation to liabilities of clients of the failed firm;
5. The administrator needs to check if the firm is on notice of any third party security interests;
6. The administrator needs to send a statement to each client and seek to agree each client's client position;
7. The administrator then needs in practice to set a Bar Date and propose a distribution plan which requires consultation with the Creditors committee and approval by the court; and
8. The plan will need to take account of the costs required to be borne by the client asset pool.

3.13 All of this needs to be conducted against the hugely complex situation set out above. All in all it would be wise to adopt a degree of realism about what a modified insolvency regime, no matter how well considered, can hope to achieve.

4 Assessment against Statutory Objectives

4.1 Set out below are the five statutory objectives listed in section 233(3) of the Banking Act , together with some observations as well as my assessment, taking account of responses to the call for evidence, of whether and to what extent the existence and operation of the SAR regime has achieved each objective. This assessment is against the five *statutory* objectives in the Banking Act as opposed to the three *administration* objectives in the SAR itself.

4.2 I am assuming that each statutory objective is of equal "desirability" (to use the statutory language), i.e. there is no hierarchy between them. Some however are more specific than others, so it is easier to measure the results of the SAR against them.

4.3 Inevitably any final assessment of SAR involves making assumptions as to how any non SAR procedure would have operated. The limited nature of the consultation exercise to date, together with the fact that none of the three cases has yet been completed, also prevents any definitive conclusions.

4.4 I begin by looking at each of the aspirations individually, and then set out my overall assessment at the end of this section.

Statutory objective 1

Identifying, protecting, and facilitating the return of, client assets.

General Comment

4.5 The use of the words "identify" and "protect" suggests that accuracy (see discussion at the end of the introduction section[1]) is one of the aspirations. Speed of return is not expressly mentioned, although it is implicit in the use of "facilitate". The SAR regulations themselves are of course more explicit in terms of seeking to achieve speed of return.

Positive Features of SAR

4.6 Three investment firms have gone into administration under the SAR: MF Global, Worldspreads and Pritchards. I have looked at the different rates of distribution of client money and assets from these three SAR administrations and compared them with the rate of distribution from Lehman Brothers International (Europe) Ltd ("LBIE") under the pre-existing administration regime for evidence that the SAR has quickened the return of client assets and money.

4.7 The differences between these administrations – not least, the scale of the firms concerned – makes it impossible to draw hard and fast conclusions from rates of distribution alone. Perhaps the most that can be determined is that the SAR has proven helpful, though it has not proven to be a panacea.

[1] Para 1.11 above

4.8 That said, whilst there is clearly frustration that greater degrees of speed have not been achieved on some of the SARs to date, it nevertheless seems to me that the following aspects of the SAR have contributed to making some progress in achieving, at least in part, this aspiration:

- the prioritisation of the Administrator's tasks to include return of client assets as soon as reasonably practicable (Objective 1);
- the market infrastructure provisions (Objective 2 plus Regulation 13(4)), requiring the market infrastructure bodies to provide information to the Administrator;
- the continuity of supply of services provisions (Regulation 14); and
- the power to establish a Bar Date (Regulation 11 and associated provisions).

Perceived Shortcomings of SAR

4.9 Implicit in some of the concerns expressed about how the SAR has worked in practice is frustration that the Administrator has no option, under the regime, but to work to reconcile positions and agree the firm's records with clients, as well as to deal with any conflicting claims or litigation which may arise in relation to client assets and money (and which may have the effect of delaying the return of the assets or money).

4.10 There is no mechanism to allow the Administrator to rely, without (potentially comprehensive) investigation, on existing records (be they those of the firm, of customers or market infrastructure bodies) in gathering in and returning client assets.

4.11 Other perceived shortcomings of the current SAR include:

- The inability to use the Bar Date procedure in relation to client *monies* (as opposed to other client assets);
- The lack of any preference (over unsecured non client creditor claims) for client asset claims;
- The lack of any immunity for Administrators, which is perceived as obliging them to adopt a very cautious approach to determining client asset claims;
- There is no mechanism to require those holding client assets and client money to return them promptly;
- The SAR provides that the costs of dealing with client assets are paid out of the client asset pool. This may complicate and delay the return of client assets while the relevant share of costs is finalised and determined; and
- The requirement to return client assets, and the absence of any mechanism to facilitate transfer of assets.

4.12 Although this is not directly linked to the SAR itself, it is worth mentioning that I understand that, in the LBIE administration, the administrators will have been able to begin making distributions to unsecured creditors before they can start making general distributions of client money. This outcome suggests significant deficiencies in the client money regime as it was understood and operated in relation to LBIE before its collapse. It is essential that any necessary modifications are made to the FSA's client money rules (and their observance) and, where necessary, to the SAR regime to ensure that such a situation does not repeat itself.

Statutory objective 2

Protecting creditors' rights

General Comment

4.13 It is noteworthy that this statutory objective refers to creditors' rights, not just to clients' rights. This indicates that the SAR was not intended to facilitate protection and return of client assets at the expense of the rights of other creditors, as further demonstrated by the lack of any statutory preference for client asset claims. This is one instance where there may be some degree of inherent tension in the aims of the primary legislation (see 4.19 and 4.38 below).

4.14 The reference to protecting creditors' rights, insofar as it relates to those creditors who are clients, indicates that the Administrator is to be expected to seek to establish exactly what those pre-existing rights are.

Positive Features of SAR

4.15 Objective 1 creates a clear basis on which the administrator is empowered to deal with client assets. He is also now under a legal obligation to "ensure the return of client assets as soon as reasonably practicable".

4.16 Another feature of SAR which "protects" client assets relates to the structure of the Bar Date mechanism. This does not totally extinguish the rights of those who fail to submit claims by the Bar Date (although they may lose out to some extent; see Regulation 11(5) and Rule 147).

4.17 Equally, those who receive distributions can be certain that their distribution will not be disturbed (Regulation 11(5)(b)).

Perceived Shortcomings of SAR

4.18 The client community is likely to see the absence of a formal claim preference, as opposed to operational prioritisation, as a weakness of the SAR.

4.19 In addition, the administrator has a duty "to achieve the best result overall for clients and creditors" (Regulation 10(3)(a)), so there is scope for tension between the respective interests of clients and non client creditors (and the duties of the Administrator towards these two constituencies).

4.20 Similarly the fact that the client asset pool bears the costs of dealing with client assets, including potentially the associated litigation, may be seen as inimical to the protection of client assets.

Statutory objective 3

Ensuring certainty for investment banks, creditors, clients, liquidators and administrators

General Comment

4.21 This is a rather generic aspiration. Once again it refers both to clients and to creditors.

Positive Features of SAR

4.22 In a sense, the principal method of achieving this aspiration has been by the creation of the SAR itself. The SAR is part of the general body of English insolvency law which, whilst complex, is generally predictable and administered by a highly experienced judicial function.

4.23 In addition:

- the SAR has given clear jurisdiction to the Administrator to deal with client asset claims. I understand that in the Lehman administration, directions were obtained from the court clarifying the status of the administrators in relation to client assets;
- the SAR now makes clear how shortfalls are dealt with and how the costs of the process of handling client assets are to be borne;
- the SAR makes clear that distributions to clients in respect of client assets cannot generally be disturbed (Regulations 11(5) and (6));
- the SAR recognises and protects the security rights of institutions holding third party client assets as security (Regulation 10(5)); and
- Regulations 12(7) and (8) expressly state that a client who does not receive a return of the totality of his client assets has a claim in the insolvent estate for the balance and establishes a valuation methodology. This removes a residual uncertainty which may exist outside the SAR.

Perceived Shortcomings of SAR

4.24 A number of complications flow from the application of general principles of English property and trust law, as established by the courts, including:

- principles established historically in relation to simpler fact situations relating to identifying clients' interests in mixed funds of client money or assets. These include questions of tracing and set off; and
- the consequences of the Supreme Court's 2012 ruling[2] on the interpretation and application of the FSA client money rules in the Lehman administration.

4.25 Similarly there is no provision in SAR allowing the Administrator to rely on the records available to him. So the SAR does not create its own complete and stand alone mechanism for resolving client asset issues. Nor is it (absent the FSCS regime) a compensation system.

Statutory objective 4

Minimising the disruption of business and markets

General Comment

4.26 I note the use of the word "minimise". The legislation therefore accepts the reality that in a case such as this there is bound to be some degree of disruption; the aim is to reduce it.

[2] In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2012] UKSC 6, 29 February 2012

Positive Features of SAR

4.27 The principal elements of the SAR which should facilitate this aspiration are:

- the Objective 1 prioritisation;
- the market infrastructure provisions (Objective 2); and
- the continuity of supply provisions (Regulation 14).

4.28 Going forward, the porting provisions of EMIR may also assist.[3]

Perceived Shortcomings of SAR

4.29 Clearly the principal shortcoming under this heading is that it still takes time to reconcile and return client assets in the cases to date. As already indicated, a significant part of this may be attributable to the state of the records of the failed firm pre-administration, as well as the complexity of the contractual relations between the firm, its clients and relevant third parties such as subcustodians.

Statutory objective 5

Maximising the efficiency and effectiveness of the financial services industry in the United Kingdom

General Comment

4.30 This again is a rather general aspiration. As a result it is hard to point to particular aspects of the SAR which tend to the achievement of the aspiration. It may also be that the most that can reasonably be expected of the SAR in relation to this aspiration is a negative one, that it does not create additional avoidable inefficiencies.

Positive Features of SAR

4.31 The fact that the SAR was established to create a bespoke mechanism for dealing with failed investment firms, together with a clear prioritisation of dealing with client assets, may have reassured the markets, post Lehman, that any subsequent investment firm failure would proceed more rapidly than has proved to be the case.

4.32 Whilst the SAR may be capable of improvement, it seems reasonably clear that it is generally regarded as being preferable to an insolvency regime for failed investment firms which does not contain a bespoke SAR procedure. In this connection, I note that no-one who responded to the call for evidence has indicated a preference for doing away with it; the focus of commentators has generally been on building on it in a more or less radical manner.

4.33 The SAR can also be seen as contributing towards this particular aspiration in another way. If part of the "efficiency and effectiveness of the UK financial services industry" is its flexibility, including a large measure of freedom of contract, then the SAR does nothing to obstruct that flexibility. For example, the SAR does not create any barriers to rehypothecation in a going concern environment; participants must however be prepared to accept the increased risks that such business may involve.

[3] Under EMIR, Central Counter Parties must commit to transferring client positions and assets on the default of a clearing member to another clearing member designated by the client, on the client's request and without the consent of the defaulting clearing member.

Perceived Shortcomings of SAR

4.34 There are two aspects of the SAR which may most clearly militate against this aspiration:

- the lack of a transfer mechanism; and
- the exclusion of Client Monies from the Bar Date mechanism.

4.35 There is a more general criticism, resulting from unfavourable comparisons with other (notably US) regimes. I am not yet in a position to form a definitive view as to how justified this criticism is, but I would reiterate, as stated above,[4] that the SAR is not designed as a compensation mechanism but as a variant of the general insolvency procedure which is more adapted to an investment firm.

General Assessment of the SAR's achievement of the statutory aspirations

4.36 My own general assessment is set out below.

4.37 The first point to make is that the Banking Act established some significant goals for the SAR regime, whilst stipulating that it should operate as a variation of existing insolvency law, rather than a stand-alone client asset preservation or compensation regime. So the burden placed on this variant of insolvency law is a heavy one, particularly as the substantive modifications to general insolvency law are fairly modest.

4.38 These wide ranging aspirations could to some extent be seen as being incompatible or at least to work against one another. The most significant source of tension among the statutory objectives is that the Administrator must *prioritise* return of client assets, but he must do so without giving *preference* to clients. To take an example, an administrator may not be able to return an asset which is clearly the property of a particular client without being certain that the failed firm does not have a right to use that asset to defray liabilities of the same client in relation to other transactions between the client and the failed firm. So what starts off as a simple issue may prove to be more complicated to resolve definitively.

4.39 Although a number of the perceived shortcomings in SAR cases to date identified above result from the SAR, and the relatively limited changes to general insolvency law which it introduced, a variety of other factors will also have contributed, including:

- the inherent structure of the markets themselves;
- the contractual webs created pre-insolvency between the failed firm, its clients and third parties;
- the state of affairs and in particular records of the failed firm;
- inevitable communications difficulties in the early day of the process;
- the conduct of counterparties (including affiliates) of the failed firm; and
- complexities arising from cross border and conflict of laws issues.

4.40 It may be that the enabling powers in the Banking Act, and the creation of the SAR, by themselves, created a sense that future insolvencies of investment firms would operate more smoothly and more rapidly than may be realistic to expect, in the absence of much more radical departures from insolvency law, or stronger underpinning of client assets, than currently exist.

[4] Para 4.25

4.41 Nevertheless I consider that the SAR, as it has operated in the three cases to date, has contributed to some of the more specific aspirations in the Banking Act. I also consider that it represents a sound basis on which to build, in the light of experience, with a view to creating an overall environment in which each of the factors (legislative, regulatory and market or conduct based) which can minimise delays in the return of client assets are further enhanced. I therefore recommend that it be retained.

5 Recommended improvements to the SAR

5.1 The SAR was introduced after a full process of consultation. It is clear that it sought to draw a balance between differing and contrasting objectives, not least the speed of distribution to clients, the desire for accuracy and the interests of all creditors. As a matter of policy, it would therefore be possible to devise regimes building on or alternative to SAR which speed up distribution of client assets by altering that balance. For example, by:

- allowing a less thorough review process before assets are handed back; and/or
- giving legal preference (over other creditors) to claims in relation to client assets; and/or
- providing for the costs of dealing with return of client assets to be paid otherwise than out of client assets; and/or
- establishing a compensation fund (or extending the FSCS) to guarantee return of some part of a client's assets, where FSCS does not currently apply.

5.2 However, the decision to move to any different regime involves making a policy determination that the interests of clients and of a rapid return of assets (or of credibility of the UK financial markets) must be given higher priority than is currently the case.

5.3 Any such change should only be made with care, as it implies a lessening of priority elsewhere, with broad ramifications for the UK's insolvency regime. But I believe that there are other changes that could sensibly be made. These are set out below.

5.4 I have divided my recommendations into sections. The first section details some concrete changes to the SAR that I am confident in recommending now. The second section sets out some further changes to the SAR where I can see potential benefits but where I recognise that further work may be required to ensure they are likely to be effective and to identify what consequential changes may be called for and to identify their broader impact.

5.5 I then include a third section that sets out a number of 'behavioural' or good practice recommendations on how firms should operate while still a going concern if an administration process is to be eased. Many of these will be relevant to the FSA's review of its own client assets regime.

5.6 And, lastly, I have also included a set of recommendations relating specifically to the FSCS and its interaction with the SAR – reflecting the importance of the FSCS in cases where there are FSCS eligible clients.

Substantive Recommendations

Recommendation 1

A mechanism should be introduced to facilitate rapid transfer of customer relationships and positions, where feasible. This could be modelled on the private sector purchaser transfer procedure in the Bank resolution mechanism, it being clear that there is no access to public funding. Other models can be found in, for example, the *Energy Act 2004*.[1] Consideration will be required as to whether, in order to be effective, this would require the temporary suspension of default rules/primary pooling events and, possibly, a brief moratorium on third party powers to exercise default rights.

Justification

5.7 One of the three priorities for the SAR Administrator is expressed to be the return of client assets. There may be cases where a transfer (at least on an interim basis) of the assets to a viable investment firm is possible. This may, commercially, be capable of achievement as part of a portfolio or business transfer and this may in fact be preferable to a return of the asset, particularly one which has a particular maturity.

5.8 In at least one example of a SAR administration, attempts were made to achieve a transfer pre-administration. In the absence of an explicit transfer tool, this was more complex and therefore less immediately successful than it could have been if a proper mechanism had been in place.

5.9 This is all the more important bearing in mind the policy of porting introduced by EMIR. There may also be cases (for example, ISA and SIPP products) where it is in a client's interest for tax purposes for the asset to be transferred and not returned.

5.10 The introduction of an explicit transfer scheme would be consistent with the principle that administration is there to 'rehabilitate' a viable business where possible. It is also noticeable that other special administration regimes – notably, that enacted in the Energy Act 2004 – do contain such a transfer scheme power.

Recommendation 2

The statutory objective in relation to client assets should be clarified from "return" of client assets to "return or transfer".

Justification

5.11 This recommendation follows logically from the previous recommendation. If a power giving the administrator a power to transfer assets is to be introduced, then it would be logical for the statutory objective on the administrator also to be modified in a consistent manner. In effect this will clarify the objectives within the SAR to match section 233(4) of the Banking Act 2009, which states that "a reference to returning client assets includes a reference to a) transferring assets to another institution, and b) returning or transferring assets equivalent to those which an institution undertook to hold for clients".

[1] The special administration regime for energy licensees established under Part 3 Chapter 3 of the Energy Act 2004.

Recommendation 3

There are a number of aspects in which the existing information sharing and co-operation provisions could usefully be extended:

- the Administrator should have a duty to co-operate with the FSCS;
- the Administrator should have a duty to co-operate with any transferee of all or part of the business of the failed firm;
- in relation to market infrastructure bodies (and any other bodies holding records needed by the administrator in order to reconcile positions of the failed firm): the duties of co-operation should be reciprocal;
- in relation to entities holding client assets of the failed firm, there should be a duty on those entities to investigate and return them promptly;
- to the extent necessary, any barriers should be removed, so as to allow exchange of confidential information between the administrator and market infrastructure bodies.

Justification

5.12 All three SAR administrators found the SAR administration objective to 'ensure timely engagement with market infrastructure bodies' to be helpful, but none of them felt it went far enough – either in scope or in reciprocity. The recommendation extends the duty to cooperate beyond market infrastructure bodies to other bodies where cooperation will be desirable in any SAR administration. It also suggests introducing certain reciprocal duties on other bodies – again, based on the experience of the existing SAR administrators and the difficulties that they have faced, in accessing information and records held elsewhere and in recovering assets trapped with third parties. The recommendation would also allow for the easier exchange of confidential information – a concern raised by a number of the lawyers engaged in the existing SAR administrations.

Recommendation 4

The Bar Date mechanism should be extended to include client monies.

Justification

5.13 In bankruptcy, the Bar Date is the deadline for people or companies to claim that they are owed money by a debtor, in order to participate in a distribution by the insolvency practitioner. The purpose of the Bar Date is to ensure that the bankruptcy process moves smoothly, and that distributions are not subsequently disturbed as a result of unexpected or late creditor claims.

5.14 The SAR currently excludes client monies from the Bar Date mechanism and so does not bring the same deadline for claims on client monies as it does on client assets. This is a matter of general frustration for the SAR administrators and some other consultees.

5.15 I understand that the exclusion was made because of the degree of uncertainty as to the legal status of client monies in view of the LBIE litigation, not because of a decision that there is some overriding policy reason why a Bar Date should not apply to client monies. I can see no reason for continuing the exclusion of client monies from the Bar Date mechanism.

Recommendation 5

The Administrator should be permitted to make distributions of client assets during the period after the Bar Date process has commenced.

Justification

5.16 Under the current SAR, the administrator is prevented from doing so. I can see no good reason for doing so and it has been an obstacle to the early return of some client assets in the existing SAR administrations. I therefore recommend removing this prohibition.

Recommendation 6

The SAR regime should clarify rights of clients to:

- income/interest/distributions in respect of client assets; and
- interest on client monies,

in respect of the period of the administration.

Justification

5.17 This is an emerging issue in the LBIE administration. Although that is not a SAR case, the issue is likely to arise on any long running SAR case. And certain litigation in MF Global, which is covered by the SAR, points to legal uncertainties in this area that an amended SAR could helpfully resolve. If such changes were to be made, then this may be an area where there is scope for the overall outcome under the UK regime to be superior to the equivalent outcome in the US.

Recommendation 7

The administrator should be empowered to make full use of communication with clients by electronic means.

Justification

5.18 The current SAR regime requires physical written communication in certain instances and this brings with it the associated costs. But many investment firms typically communicate with their clients electronically. Empowering SAR administrators to communicate electronically will reduce costs with no obvious downsides

Areas requiring further research and consultation

5.19 The above recommendations are ones that I am confident to make now. There are then a number of other areas where I can see possible improvements, but need more time to consider them and intend to do so as part of the second phase of my review.

Administrator immunity

5.20 Many of those I have consulted have suggested that one obvious improvement of the regime would be to introduce at least some measure of exoneration for administrators for their

actions in returning client assets. This, it is said, would allow them to be less cautious in identifying and returning client assets.

5.21 I recognise that administrator liability (and, just as importantly, associated reputational issues) is one of the factors which affect how SAR cases are handled and the time it takes for client assets to be returned. The responsibility of administrators is itself a consequence of the SAR being a variant of general insolvency law, with the administrator an officer of the court.

5.22 However, any proposal to introduce administrator exoneration needs to be coupled with suitable proposals as to where any losses fall (or as to the source of compensation) in any case where it subsequently transpires that a client has received more than he should have, leading to added losses borne by other creditors.

5.23 The regime relating to an insolvency office holder's duties is well established and is designed to protect creditors of any failed company. It is not clear to me at this stage that the preferred method of rectifying perceived deficiencies in the SAR is to derogate generally from this well established regime and to create a situation where unsecured creditors of an investment firm, whilst not being subordinated to clients of that firm, have weaker protections than unsecured creditors of another firm outside that sector.

5.24 Any move to generalised administrator exoneration might require clarification of the tension between the prioritisation of actions relating to client assets and the lack of any formal legal preference for their (shortfall) claims. In addition, this proposal presupposes that the situation is one where assets are already under the control of the administrator and there is no litigation which would preclude the distribution of client assets.

5.25 For these reasons, I am not at this stage making an express recommendation to introduce any element of general administrator exoneration. However, I consider that there could be a case for some limited specific immunities to be introduced for SAR administrators, as follows:

- examine the possibility of authorising administrators (on a liability free basis) to agree "speedy" returns to individual clients in straightforward or hardship cases. Clients would surrender the right to complete accuracy, but remain on the hook for any liabilities to failed firm. This would require a mechanism to deal with any credit risk or losses to the assets as a result of such deals; and
- to protect administrators from "unfair prejudice" type claims from unsecured creditors if the administrators choose to keep on more staff than may be absolutely necessary, in order to ensure no loss of corporate memory/ systems knowhow. For clarity, this is not intended to extend to depriving any employees of the rights and priority which they have under general law. So it follows that the administrator would in practice need to be satisfied that he has funds available in the estate to meet any such claims.

5.26 The first of these immunities would help deal with the risk that a "straightforward" client becomes unwittingly caught up in the complications arising because, for example, of the existence of much more complex transactions involving assets which are fungible with those of the straightforward client.

5.27 A particular failed firm may have a multiplicity of differing client relationships, some complex and others very straightforward, the most obvious example of the latter being where the failed firm simply holds a client's assets in circumstances where the client owes the firm no money and is not the subject of transactions which have not yet completed at the time of the failure.

5.28 If the SAR regime does not sufficiently encourage the return (or transfer) of the asset of the straightforward client outside the Bar Date process, consideration should be given to expressly

encouraging an administrator to do this and to providing him with a specific exoneration when acting in good faith if it subsequently turns out, for example, that there is an unexpected shortfall in the asset class. Even in such straightforward cases, a degree of verification would be required before the administrator could return the client's asset. Any such mechanism would also need to provide for how any such shortfall is borne or compensated.

5.29 The second possible immunity would respond to the loss of corporate memory that can occur when an administrator takes on a failed firm. This concern was raised by several of those I consulted. Giving the administrator a degree of protection as set out above could go some way towards addressing the concern.

Other possible changes to the SAR

5.30 There are a number of other suggestions that I would like to explore further, all of which respond to points that have been made in my consultations with industry and the SAR administrators. These are set out below:

- how a power, giving an administrator the ability to override standard client contract provisions to facilitate transfers and also to close out contracts, might operate in practice;
- there will be instances, certainly in relation to retail clients, where the return of the client asset or money could be detrimental, and where his interest is to see the asset or money transferred to a solvent investment firm. This applies notably to tax favoured products such as ISAs or SIPP portfolios. For these products, an element of concertation (i.e. dialogue and co-decision) with HMRC may be required as part of an effective and efficient process;
- whether any part of the Bar Date procedure can be simplified or dispensed with, in cases where the administrator has already agreed a position with a particular client; and
- extending the SAR rules to simplify/ codify some of the complexities and sources of delay which may arise from strict application of common law or equitable property/trust rules (for example by simplifying rules in relation to tracing or set off) to client assets.

'Behavioural' recommendations

5.31 My terms of reference specifically instructed me to consider practical and non legislative changes could be implemented better to deliver the objectives of the SAR.

5.32 The theme which has been repeated most consistently in my limited consultations to date is that lack of clarity in the failed firm's records as to client asset entitlement (and rights between group members, where relevant) is the principal cause of delays in returning those assets.

5.33 Thus, the more that can be done from an operational and regulatory point of view to ensure that, in going concern mode, a firm's records are accurate, updated and (as necessary) reconciled, the fewer problems there ought to be in returning those assets to clients. Of course, where a client is himself a professional (perhaps managing assets of his own clients, or else purchased with monies supplied by his own clients), the responsibility of clear record keeping and verification should apply as much to the client as to the investment firm.

5.34 Similarly, failed or unsettled trades present particular complications when a firm fails, particularly if a client's settlement monies are trapped within the failed firm. If there are any steps that can be taken both by individual firms and by market infrastructure bodies to minimise these and to monitor any persistent problems, it is evident that any administrator's task will be facilitated.

5.35 SAR cases will typically arise suddenly and without much time for preparation. So the early flow of (reliable) information between interested parties needs to be facilitated.

5.36 Given the importance of these procedural and administrative matters, I set out a number of recommendations in this area below. In some cases, they may seem so obvious that they could go unsaid, but, given their importance, I make no apologies for including them. They matter and should be a priority both for investment firms themselves and those who regulate them.

5.37 Implementing these would require a combination of action or encouragement by regulators and other authorities and establishment of best practice standards by individual firms and the market, with prompting from the (professional at least) client community.

5.38 I recognise that steps have already been taken in a number of these areas, but more can and should be done.

- Good record keeping is essential. Some firms may need to improve the quality their firm records. Practices of reconciliation of firm and client or counterparty records may need to be enhanced. Clients should be encouraged to review statements received from investment firms. Consideration could also be given to a measure of standardisation of the data supplied, or at least the notes provided (notably in relation to transactions which may not have been completed).

- Clients need to be able to understand the statements they receive. Firms should make sure clients (especially retail clients) are able readily to understand the contents of client statements, particularly in relation to the status of ongoing trades. Regulators should ensure that that is the case.

- Client asset and money rules need to be fully understood. I have not focused on this area at this stage, in view of the FSA's ongoing CASS review. But once the new regime is established, it will clearly be essential to ensure that the rules operate as intended and are fully and properly understood by both regulators and regulated.

- Intragroup relations need to be clear and transparent. A common feature of the Lehman and MF Global cases (at least) is the particular lack of clarity in relation to intragroup relationships and entitlements. It is now evident that lack of clarity on these can seriously disrupt return of client assets. Investment firms in groups should therefore make an effort to remove any ambiguities in their contractual and entitlement arrangements in this area. Regulators should focus on ensuring that this is the case and should consider whether CASS resolution packs for investment firms that are parts of a group should contain copies of the principal long term intragroup agreements.

- Improvements to communications should be considered. FSA, FSCS and HMRC should explore whether dialogue and co-operation between them on SAR cases could be improved; making sure the existing gateways for exchange of information are adequate. These authorities should also consider whether there are any lessons from the cases to date that could be better communicated. The complexities of what products are and are not protected by FSCS would be one example.

- Changes to the SAR regime should be tested. At a future point, the authorities should consider operating "test cases" of a hypothetical SAR taking into account improvements made as a result of this review or otherwise, any changes the FSA makes to the CASS rules following its own review of those, and, importantly, taking account of EMIR.

- CASS Resolution Packs can be developed and improved. The FSA (and its successor bodies) should look to build on CASS resolution packs. In particular, it should ask

insolvency practitioners with SAR experience to suggest how they could be made more useful. In this connection, it should be noted that a failed investment firm may not have been subject to the requirement to produce a "living will".

Recommendations relating to the FSCS

5.39 My final set of recommendations relate to the FSCS regime. The FSCS plays a critical role in any SAR case where there are eligible clients. In all relevant cases, early FSCS involvement and preparation, ideally before insolvency, are critical and this should be facilitated by all parties wherever possible. Without the client data the FSCS cannot make payments, so the earlier the FSCS (and any administrator) can start to prepare, the better. This would materially shorten payout times.

5.40 If a particular client is eligible and made an investment through a failed investment firm, he may be entitled to compensation from the FSCS (subject to a limit of £50,000). Not all investment products are covered by FSCS compensation and it seems that a degree of complexity, and consequent delay, has arisen in some of the SAR cases to date in identifying which products (or components of complex products) did and did not qualify for FSCS compensation. Additionally, the definition of eligible client in this context (which derives from mandatory EU law) is itself not straightforward. It is not the same as the FSA's categorisation of retail client. The FSA has sought to address this in its Policy Statement 12/15 of September 2012, with the result that most individuals are now eligible to claim compensation from the FSCS and that the FSCS no longer needs to carry out individual assessment of the eligibility status of most claimants.

5.41 Involvement of the FSCS has to date entailed co-ordination between the FSCS and the Administrator to:

1. identify eligible clients and eliminate any duplications;
2. identify and separate protected and excluded investments of eligible clients;
3. collect from the Administrator data in relation to eligible clients and protected investments;
4. obtain confirmation from the Administrator that reconciliations have been carried out and agreed with the customer; and
5. enable the FSCS to submit to eligible protected customers application forms and obtain signed assignments from them (in the SAR cases to date).

5.42 FSCS compensation can only be paid after these processes have been completed.

5.43 Compensation in relation to losses suffered in relation to failed investment firms is therefore somewhat more complicated than in relation to protected bank deposits, where a number of measures have been taken (notably the establishment of the single customer view exercise by all deposit takers) to streamline the process. The FSA has sought to address this situation by extending some of these measures to investment and other claims (see 5.45 below). These changes have not yet been put to the test, but it is hoped that they will be a useful contribution to streamlining and speeding up the FSCS process for the clients of failed investment firms.

5.44 All this takes time, especially as in cases to date there has been little or no opportunity for pre-planning on the part of the FSCS because of the sudden nature of the SAR cases. This inevitably creates a drag on the FSCS' ability to start making payments to eligible customers.

5.45 Some improvements could be found just by better and earlier cooperation between the SAR administrator and the FSCS and, in line with this, I suggest above a specific duty to cooperate with the FSCS.[2] But other improvements could also be made.

- Clients need to understand when they are protected and the limits of that protection. Could going concern investment firms records make clearer which clients and products fall within FSCS scope, so as to facilitate and accelerate payouts? Should, for example, separate client statements be produced for protected/non-protected investments? Could more be done to share and publish the learning that has been achieved on what investments are or are not protected?

- The current FSCS product perimeters could be reconsidered (though this would mean going beyond the scope of The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 and broadening the scope of regulation, both of which may be difficult).

- Could the FSCS be used as a mechanism to facilitate transfers? This has been the case in certain banking resolution transfers, and the FSCS may also fund insurance portfolio transfers. If such an approach could be adopted for an investment firm also, then it would be critical to ensure that FSCS protection is not lost by reason of a transfer. Is there a possibility of FSCS subsidy of shortfalls in a portfolio transfer, in lieu of compensation? Could the FSCS have a role in making *de minimis* payments to eligible clients? The recent changes to the FSA's Compensation Rulebook (COMP), as published in FSA Policy Statement 12/15 (September 2012), make welcome changes to the FSCS's rules in that regard. FSCS may now (i) pay compensation without undertaking a full investigation (including as to quantum) where the costs of doing so would be disproportionate; (ii) pay investment claims without requiring an application form; (iii) have the option to take an automatic assignment or transfer of claimants' rights; and (iv) fund a client money shortfall payment by transfer to another firm. These reflect some of the lessons from the banking crisis and recent failures.

- More could be done to ensure that the FSCS has access to the information it needs to facilitate a payout. The FSA and FSCS should explore if any parts of the streamlined banking compensation scheme can be applied to investment firm failures. For example, is there any record keeping process, falling short of full SCV,[3] which would facilitate or accelerate payment of compensation? Or should CASS Resolution packs include a list of eligible investors and the protected investments by category?

- Other changes should also be considered to help the FSCS payout more quickly. There is also a case for the FSCS to have the right to sit on the creditors committee (at least as an observer) from outset, as it is often likely to become a major creditor, and will need to work closely with the administrator.

[2] Recommendation 3 on page 25

[3] Single Customer View file

6 Conclusions and next steps

6.1 My overall conclusion is that the SAR regime should be retained, but subject to a number of changes and amendments. While it has not fulfilled the full range of objectives set for it – and arguably never could have done so, such is their ambition – I nevertheless consider that it does fulfil a useful purpose.

6.2 But it can and should be improved. I have set out in this report a range of options for enhancement either of the SAR regime, or of the operations of investment firms. These recommendations are based on my discussions to date, since I was appointed in November 2012. I recognise that, on further consideration, some may not be feasible, or may be uneconomic; equally they may not by themselves be adequate. In the second phase to this review, I plan to take feedback on these recommendations and, as necessary, adapt or build on them.

6.3 Inevitably these recommendations apply hindsight; it is desirable for the markets, encouraged by regulatory and supervisory bodies and trade associations, also to look forward and give some thought to what new complexities might arise in the light of market or legislative developments since LBIE and the three SAR cases to date. Perhaps the most obvious questions relate to how SAR and the porting provisions of EMIR will interact.

6.4 Any definitive recommendations for reform or improvement of SAR will of course need to reflect proposed changes to the FSA's own CASS rules – and this report contains a number of 'behavioural' recommendations that I hope the FSA will reflect on as it concludes its review of those rules. Several respondents to the FSA's consultation in relation to changes to the CASS regime stressed the desirability of holistic reform, encompassing both the CASS rules and applicable company law and insolvency rules. It is worth remembering that the litigation around client monies in the Lehman case, ultimately going to the Supreme Court (and therefore a major factor in delaying distribution), was principally concerned with an interpretation of the FSA's client money rules. The recent court High Court judgement on the MF Global 'Hindsight Application' case reinforces the need for such a holistic approach.

6.5 It will similarly be important to assess the overall package of measures eventually proposed to supplement the SAR, to make sure that they do not, in aggregate, create a burden on investment firms, or the market more generally, which is disproportionate.

6.6 I will seek to test the conclusions and recommendations set out in this report during Phase II, with the intent of producing a final report to the Treasury in July 2013. I will also consider further a number of areas or topics that have been drawn to my attention. For the sake of transparency, I have set these out in Annex B.

This will require further consultation. The first stage of that will see a call for evidence on the ideas and suggestions set out in this report.

A Terms of reference

The review must consider, in particular:

(a) how far the regulations are achieving their objectives (specified in section 233(3) of the Banking Act 2009); and

(b) whether the regulations should continue to have effect.

In addition, the review must consider what other changes to law or practice, if any, would better deliver the objectives of the SAR.

In so doing the review must, as a priority, assess what practical and non-legislative measures could be implemented to deliver the objectives of the SAR more effectively.

In assessing what legislative changes could achieve in delivering the objectives of the SAR, full account must be taken of the impact of any such changes on the UK's insolvency regime.

The review should take account of the consensus reached in the creation of the SAR, building on the earlier public consultation on the SAR.

The review must be delivered in co-ordination with the FSA's review of its own Client Assets Rulebook and engage fully with that review. The review should consider the SAR's interactions with the FSA regulatory regime (CASS, Prudential etc) and FSCS compensation regime, and set out clear recommendations to ensure that there is a robust and holistic framework. The review should draw on the FSA's findings and industry consultations and seek to establish an agreed set of recommendations.

The review must engage fully with stakeholders, including, but not limited to, the FSA, the Bank of England, the Insolvency Service, insolvency practitioners, the Financial Services Compensation Scheme, and investment firms and their clients. There is no expectation that the review will undertake a formal public consultation.

Scope

The review must assess the impact that the SAR has had on individual clients, creditors, other stakeholders and the wider market. In so doing the review will analyse the impact of the SAR in dealing with the insolvencies of MF Global, Worldspreads and Pritchards. It will evaluate what benefits have been derived from the new legislation, benchmarked against the difficulties experienced during the administration of Lehman in the UK. The assessment must take account of the legal cases arising from these insolvencies.

The review should consider whether the scope of the SAR is appropriately defined and whether it captures the right population of firms.

The government is consulting on a Special Resolution Regime for non-banks, including investment firms. The review should maintain the distinction between the proposed SRR and the SAR. The review should nevertheless be aware of and take into account the findings of the SRR consultation, and should consider whether any elements of the SRR should be replicated within the SAR.

Comparisons may be made to the equivalent processes in other countries, for example the US. The assessment will include how effective the regulations have been in minimising any disruption to business arising from an insolvency, and in maintaining the UK as a global centre for financial services.

Examples of the type of measure that the review could consider include, but are not limited to:

- co-ordinating with the FSA over changes to the FSA's CASS rulebook;
- limiting the liability of insolvency practitioners dealing with the insolvency of investment firms;
- applying client preference over general creditors in the insolvency of investment firms;
- creating an industry-funded compensation scheme for investors, offering additional protection to investors beyond that received from the Financial Services Compensation Scheme;
- enabling the transfer of business from an investment firm facing insolvency.

The review should clearly articulate what the SAR is designed to achieve, in the light of any changes suggested to improve it.

Two phase approach

The review will be split into two phases.

The first phase will address the core questions in the Terms of Reference: how far the regulations are achieving their objectives, and whether the regulations should continue to have effect.

It will identify the perceived shortcomings of the SAR, including any failure to meet its objectives, and set out an initial work programme for the second phase that will consider what other changes to law or practice, if any, would better deliver the objectives of the SAR.

The first phase will focus in particular on paragraph 1 of the Terms of Reference. It will focus on paragraphs 2 and 3 in developing the work programme for the second phase. It will take into account paragraphs 4-13 in its planning.

The second phase will deliver the work programme, in accordance with the Terms of Reference set out above.

The Terms of Reference apply in full to the second phase.

Outputs

Present a written report to Ministers by 7 February 2013, comprising:

- Clear assessment of how far the regulations are achieving their objectives and whether the regulations should continue to have effect;
- An identification of the perceived shortcomings of the SAR, setting out areas for further work;
- A work programme for the second phase of the review.

Present a second written report to Ministers comprising:

- Recommendations about how the regulations could be improved;
- Recommendations about whether the regulations should be replaced;

- Clear recommendations about what other changes to law or practice, if any, would better deliver the objectives of the SAR, together with an assessment of their practicability.
- Recommendations about further work required to deliver any further assessment of these options.

The report will include evidence and analysis, assessment of options, conclusions and recommendations based on the evidence and analysis. It will take into account the views of stakeholders. It will not deliver draft legislation.

B Areas for further exploration

B.1 In this section, I set out a number of areas or topics which have been drawn to my attention or which I consider may merit further work as part of Phase II.

B.2 Some more detailed points have been made by those who have been kind enough to contribute to the review so afar and I propose to reflect on them and take them up with the consultees concerned.

Costs

B.3 It may be that delays in the return of client assets occur in part because the costs of dealing with client assets are borne by those assets. This requirement may also lead to (increased) shortfalls in client assets. If so, it is worth exploring the alternatives. On the fact of it, it is likely that the only reliable substitute would be for there to be a buffer fund, either at firm or market level, as there could never be certainty that the failed firm's free assets would be sufficient to cover these costs.

Client preference

B.4 The fact that under SAR (and as seemingly intended by the Banking Act) there is no preference for client asset (including shortfall) claims, over the claims of unsecured creditors, is perceived to contribute to delays in the return of client assets. It would be useful, as a first step in exploring this issue further, to collect data on the potential improvements in outcome for clients which might have resulted if there had been a client preference regime in the three SAR cases to date.

Administrator immunities

B.5 In view of the fact that this topic has been raised on multiple occasions in the exercise so far, it should be kept under review. I have already proposed the introduction of some very specific protections for administrators in relation to particular actions they may wish to take.[1]

B.6 Quite apart from the fact than an administrator may wish to do the right thing, whether or not he has an indemnity, it must be recognised that offering immunity, partial or total, to administrators of a failed investment firm does not by itself solve the problem of ensuring rapid return of client assets. Any such regime would need to be accompanied by a loss allocation and/or compensation regime in relation to losses sustained by the estate as a result of honest (and irrecoverable) errors in returns of assets based on incomplete information. Further, in many cases it will be necessary to recover the underlying client assets from a third party, with corresponding delays in dealing with reconciliation questions.

Role of creditors' committees in SAR cases

B.7 I recommend that more consideration be given to how creditors' committees are constituted and operate in SAR cases and, in particular, whether they (in conjunction as appropriate with

[1] Para 5.30 above

the regulators and the FSCS) could be empowered (provided they operate with sufficient independence) to approve some of the more detailed proposals of the administrator in relation to particular client assets (or classes), with a corresponding degree of protection for the administrator.

Role of the courts in SAR cases

B.8 A number of the contributors to the review to date have encouraged me to give thought to the role of the courts in SAR cases. In the time available to produce this first Report, it has not been possible to give proper consideration to what, if any, role the courts might play in any enhanced regime for return of client assets of a failed firm. I would propose to take forward this aspect as part of Phase II.

B.9 It has also been suggested that existing court procedures are not the best forum in which to bring to the attention of the courts the practical and operational complexities underlying issues for judicial determination. Consideration could be given to whether there would be merit in offering judicial seminars, perhaps under the aegis of the Financial Markets Law Committee, to brief the judiciary on relevant aspects of market operations affecting failed investment firms.

Differing default rules

B.10 It has become apparent that the various institutions providing infrastructure or central counterparty services apply differing default rules. Consequently an institution which is inclined to show flexibility in the application of its own rules (for example in order to facilitate transfer of business from a failed firm) may find that the application of the default rules operated by another institution involved in the process precludes this.

B.11 There are likely in many cases to be to be good reasons for divergences between default rules, but there may be merit in reviewing them with a view to seeing whether there are any changes which could be made in order to facilitate protection and return or transfer of assets of underlying clients of failed firms.

B.12 The decision in relation to whether default rights are to be exercised in any particular case is an area where co-operation and consultation should be encouraged, with a relaxation of confidentiality duties, if required.

Application of general principles of property and trust law

B.13 In a commingled fund, particularly if there are shortfalls, the SAR regulations will be supplemented by applying general rules of English property and trust law or equitable principles. These can be very complex and time consuming and may not be well adapted to the rapidly moving dematerialised processes which operate to record ownership, and effect transfer, of interests in securities. It may be worth considering the merits or otherwise of a move to a standalone mechanism for determining client asset entitlements.

Learning from LBIE and the current SAR cases

B.14 In the *Lehman* case, there are a number of areas where the administrators and their advisers had to negotiate a consensus among clients because of the absence of clear rules. I recommend that there should be a more detailed study of Lehman case and the three current SAR cases to identify any further points which could usefully be addressed or clarified as part of changes to SAR.

B.15 Similarly, it is desirable to monitor the development of the current SAR cases, for aspects of SAR it would be useful to clarify or add to.

B.16 A particular point which may deserve reform or clarification relates to valuation of client asset claims in the light of post administration events. This will need to be reviewed in the light of the High Court judgement on the "hindsight" litigation in the *MF Global* case.

Interrelationship between CASS, SAR and general insolvency rules

B.17 One of the major causes for delay in distribution in the Lehman case was litigation around client monies, which ultimately went to the Supreme Court. This litigation was principally concerned with an interpretation of the FSA's client money rules. The recent court High Court judgement on the MF Global 'Hindsight Application' case reinforces the need for a holistic approach. I will want to explore the possibility of guidance on the interrelationship between CASS, SAR and general insolvency rules.

Segregation

B.18 The FSA CASS review has already initiated a debate on this topic. I do not propose to comment on this in any detail at this stage, except to make the point that, under current rules, it seems that a client whose relationship with a failed investment firm is very straightforward (for example, a custody role on the part of the failed firm, with no unpaid amounts, potentially giving rise to set off claims, owed by the client) can be caught up in the greater complexities of other clients' positions, for example if there is a shortfall in the asset class held for the "straightforward" client. An obvious question which arises is whether there should at the very least be a facility for such straightforward clients to have their custody assets insulated from pools of client assets held subject to more complicated contractual rights.

EMIR

B.19 It is possible that the introduction of EMIR and its porting provisions may introduce new uncertainties into the regime of holding and dealing with client assets and client money. EMIR may also create expectations whose fulfilment cannot be guaranteed. Porting might have the effect that one client may end up with a more favourable result than another client in a similar position prior to the firm's failure. It would be desirable to carry out some contingency planning as to how the EMIR and SAR rules would interact in the event of a firm failure, with a view to identifying any changes to SAR which would reduce the risk of uncertainties or friction between the two regimes.

Scope of SAR

B.20 It would be sensible to take the opportunity to consider whether the scope of SAR, notably the types of institutions which are excluded, is still appropriate.

Summary of financial sector insolvency regimes

B.21 In view of the number of special procedures which are now available as a result of the Financial Services Act 2012, consideration should be given to producing guidance explaining the differences between the various regimes, including:

- which only apply in systemic cases;
- the categories of entity to which the each regime applies;
- the trigger for application of each regime;
- the principal objectives of each regime;
- who has power to invoke the regime; and

- if relevant, the differing roles of the authorities (post 1 April) in the various regimes.

B.22 Some submissions I received also drew attention to the fact that the triggers which apply for a firm entering one of the various special insolvency procedures for firms in the financial services sector differ according to the nature of the procedure. In many cases there is likely to be an objectively justifiable reason for having different tests; nevertheless the various triggers should be examined with a view to checking whether there is any degree of useful harmonisation (and not just extension for the sake of uniformity) that can be introduced to the range of triggers.

Bar date

B.23 The Bar date mechanism which currently exists in the SAR has been described as a "soft" Bar Date. This is a reference to the fact that the claims of those who fail to meet the deadline fixed under the Bar Date procedure for submitting claims are not extinguished. This may in part have been influenced by concern not to depart from the traditional approach to proof of claims in insolvency as well as by concerns about challenges under Human Rights legislation to any mechanism which could be characterised as expropriating a person's property or rights. A "soft" Bar Date complicates (and potentially delays) the return of client assets. It would be desirable both to investigate further how much complication and delay this has caused in SAR cases to date and to explore whether there are any alternative ways of dealing with non claimants, which would have less prejudicial knock on effects on other clients.

Schemes of arrangement

B.24 There may be merit in considering whether the scope of Schemes of Arrangement could be expanded so as to allow them to deal with proprietary claims (and also overseas law governed contracts, subject to the "sufficient connection" test being met).

Overseas issues

B.25 I recommend an exercise to examine in detail the perceived benefits of US or other systems, notably the SIPA[2] regime and the Article 8 Uniform Commercial Code "securities entitlement" framework.

B.26 I consider this should include a practical comparison, once the *LBIE* and *MF Global* cases are substantially complete (in terms of return of client assets) of the comparative outcomes for clients under the two systems.

B.27 A separate challenge is to consider what, if anything, can be done to ensure consistency and co-operation in cases of a failed firm with overseas operations, or (as is almost inevitable) non UK subcustodians or similar.

Reliance on records

B.28 A number of submissions made to me suggested that the process of return of client assets could be accelerated if the SAR included a mechanism to allow the administrator to rely on pre-existing records in relation to the investment firm. This is an attractive proposal (at least in the absence of evidence of fraud) and one which deserves further investigation.

B.29 It is however immediately apparent that, even in simple cases, there may be multiple different records covering any particular transaction (or its various stages from instruction to

[2] The US *Securities Investor Protection Act 1970*

completion), including, for example, those of the failed firm, of its client, of any counterparties in relation to incomplete transaction as well as of bodies such as the LSE and Crest.

B.30 In addition, statements sent to clients may have shown what was in course of execution rather than what had actually been completed. So some degree of reconciliation between these various records is likely to be inevitable. Without it the client asset, assuming it had been generated or transformed prior to the failure, may not be returned to the administrator by a third party holding it.

C List of acronyms

CASS	FSA's Client Assets Sourcebook, the part of the FSA's Handbook that contains the conduct rules applicable to FSA authorised firms relating to client money and custody assets.
EMIR	European Market Infrastructure Regulation
FSCS	Financial Services Compensation Scheme
HMRC	Her Majesty's Revenue and Customs
ISA	Individual Savings Account
LBIE	Lehman Brothers International Europe Limited
SAR	Special Administration Regime
SCV	Single Customer View file
SIPA	The US Securities Investor Protection Act 1970
SIPP	Self-Invested Personal Pension
SRR	Special Resolution Regime

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ISBN 978-1-909096-64-6