

Final review of the Investment Bank Special Administration Regulations 2011:

by Peter Bloxham

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Key recommendations

For ease of reference, I provide a summary of my recommendations below. However, with brevity comes the risk of less clarity. It is important to read the relevant chapters, from which they are taken, to fully understand the detail of, and reasoning behind, my proposals. Some of the recommendations are quite complex and so it has been difficult to provide summaries which are both full and succinct. The table below identifies the source pages for each recommendation. Where a particular recommendation relates to a number of topics in the groupings below, it is repeated.

Recommendation	Page reference
A. Facilitating transfers	
Transfer mechanism	
1. Introduce a SAR mechanism to facilitate rapid transfer of customer relationships and positions, where feasible. (SAR Objective 1)	Pages 37-38
Return/Transfer objective	
2. Amend relevant SAR objective from “return” of Client Assets to a more explicit reference to “return or transfer”.	Pages 37-38
Use of Nominee Companies	
3. FCA should consider encouraging firms, in appropriate cases, to use a wholly owned subsidiary as the nominee company to hold legal title to client investments (other than cash).	Pages 38-39
B. Bar Date reforms	
Extend Bar Date to Client Monies	
4. Bar Date mechanism should be extended to include Client Monies.	Pages 39-40
Align treatment of Client Money and Custody Asset claims	
5. SAR treatment of claims associated with client monies to be aligned more closely with treatment of claims relating to Custody Assets.	Pages 20-22
Permitted Distributions	
6. The Administrator should be permitted to make distributions of certain Custody Assets during period after the Bar Date process commenced.	Page 40
Final Hard Bar Date	
7. Where the Administrator has set one or more ‘soft’ Bar Dates, SAR should allow for a final ‘hard’ Bar Date to be set that is definitive and exhausts client claims.	Page 40
C. Making CASS and SAR work together better	
Client Assets: Consistency	
8. SAR and CASS need to be consistent: clarity on clients’ rights to income, interest and/or distributions in respect of Client Assets and interest on Client Monies, in respect of period of administration, and which rules to apply.	Pages 15, 20-22, 41
Clarify SAR Objective 1	
9. Amend drafting of SAR objectives to provide that Administrator’s role in pursuing Objective 1 is to apply the applicable distribution regime laid down by CASS. This is to make clear that the client’s entitlement as a client is to be sought in CASS.	Page 15

Recommendation	Page reference
Relationship between CASS and SAR rights	
10. Ensure relationship between client's rights under CASS in respect of Client Assets and its rights to make claims as a creditor are clearly set out and understood and do not operate unfairly to other creditors.	Pages 20-22, 41-42
Clarify basis for Client Money shortfall claims	
11. SAR should set out the basis on which clients making partial recoveries of Client Monies under CMP Entitlement are entitled to make claims against the failed firm's estate.	Pages 21-22, 41-42
Costs Apportionment	
12. SAR guidance needed on how costs borne by the failed firm's general estate and client money estate should be apportioned.	Pages 20-22
Harmonisation of treatment of Client monies and Custody Asset claims	
13. Harmonise SAR treatment of Client Money and Custody Assets unless there is a good reason not to.	Pages 20-22, 41-42
Extension of Hindsight Principle	
14. FCA to consider whether Hindsight Principle could be introduced for CASS Client Money Pool Entitlement purposes.	Pages 21-22
D. FSCS recommendations	
Shortfalls	
15. FCA should consider extending FSCS compensation for portfolio transfers to cover shortfalls in Custody Assets as well as Client Money shortfalls (provided they fall within the scope of FSCS protection).	Pages 42-44
Firm records	
16. Firms in going concern mode should do more to ensure their records would assist Administrators and FSCS to understand the status of their clients for FSCS purposes and how their products are structured and consequently whether FSCS may be able to provide compensation.	Pages 42-44
Statements on FSCS Entitlements	
17. Firms should consider explaining in customer statements the circumstances in which FSCS might provide compensation if firm failed and elements of a product that would not be covered.	Pages 42-44
CASS Resolution Packs	
18. CASS resolution packs to contain sufficient data to enable Administrator and FSCS to more speedily identify eligible clients and whether FSCS can provide compensation in relation to any parts of the business of the failed firm.	Pages 42-44
Creditor committees	
19. FSCS should be entitled to sit on creditors' committees, regardless of whether it has yet made compensation payments, unless it is clear that no compensation will be payable.	Pages 42-44
Verifying claims	
20. Consider alternative methods of providing FSCS with comfort as to rigour of Administrator processes in relation to verifying claims of FSCS eligible clients, such as FSCS working alongside Administrator or agreeing a suitable methodology. This is designed to address delay caused by FSCS verifying Administrator's calculations.	Pages 42-44

Recommendation	Page reference
E. Information sharing and cooperation duties	
Co-operation between Administrator, FSCS and transferees	
21. The Administrator and FSCS should have a duty to co-operate with each other and should have reciprocal co-operation duties with any transferee of all or part of the business of the failed firm;	Pages 45-47
Co-operation between Administrator and market bodies	
22. The Administrator and market infrastructure bodies (or any other bodies holding relevant records) should have reciprocal duties for the purposes of reconciling positions of the failed firm;	Pages 45-47
Co-operation by entities holding Client Assets	
23. Entities holding Client Assets (including Client Monies) of failed firm should have a duty to investigate and return them promptly;	Pages 45-47
Co-operation by Banks holding Client Monies	
24. Banks with Client Money deposits should have duty to assist with reconciliations and return of Client Money.	Pages 45-47
Co-operation by Counterparties	
25. Counterparties of failed firm should be required to respond promptly to the Administrator's request for information and financial data such as close out valuations.	Pages 45-47
Co-operation to facilitate incomplete trades	
26. Reciprocal cooperation of administrator and relevant parties should extend so as to explore feasibility of completing client trades that are incomplete at moment of failure.	Pages 45-47
Co-operation involving HMRC	
27. HMRC should have a duty to cooperate with Administrator to address barriers to speedy resolution of issues relating to tax privileged investments such as ISAs and SIPPs.	Pages 45-47
F. Other SAR recommendations	
Speedy returns	
28. Administrators should be protected from any liability if they agree "speedy" returns to individual clients in straightforward, hardship or small value cases. Clients would surrender right to complete accuracy, but remain on the hook for any liabilities to the failed firm.	Pages 24, 47-48
Staff retention	
29. Administrators should be insulated from "unfair prejudice" type claims from unsecured creditors if keeping on more staff than absolutely necessary – to ensure no loss of corporate memory/ systems knowhow.	Pages 24, 47-48
CASS Resolution Packs	
30. FCA to seek views on proportionate additions to CASS Resolution Packs, to provide maximum assistance to Administrator and FSCS to achieve speedy return or transfer of Client Assets, and prompt payment of FSCS compensation where available.	Page 48
Reporting formats	
31. Every firm's CASS Resolution Pack should contain a detailed explanation of how client statements are presented. The particular methodology used by a firm should be clearly set out as part of the client statement.	Page 49

Recommendation	Page reference
Restrictions on Status Changes (“Switching”)	
32. Clarity regarding status of professional clients who, having contracted out of CASS, seek to switch back from unsecured creditor to client status, to maximise their protection. Switching only to be allowed to take place after the firm’s records (and if necessary transfers between firm and client accounts) has been updated to reflect the client’s change to protected client status.	Pages 49-50
Electronic communication	
33. Administrator should have power to communicate with clients using email.	Page 50
Close Out Power	
34. Administrator should have power to unilaterally to close out open positions on unhedged options or futures contracts, etc.	Page 50
Insolvency rules	
35. Review general insolvency rules (and any future amendments) to consider what aspects should be reflected in SAR Regulations or Rules.	Page 51
Future proofing	
36. Establish a mechanism for regular monitoring of changes in transaction structures and firm operations and consider what updates of the CASS Rules (or regulation more generally) or the SAR may be called for.	Pages 51-52
EMIR	
37. Consider how the interaction of EMIR and SAR rules would work in a firm failure, so as to seek to identify uncertainties and frictions between them and amend the SAR rules accordingly.	Page 52
Scope and title of SAR	
38. Insurance brokers should continue to be excluded from the scope of the SAR.	Pages 52-53
LBIE & MF Global judgements	
Lessons learned	
39. Compare overall outcomes for LBIE & MF Global clients and creditors, once cases complete, to ensure all applicable lessons are learnt from them.	Pages 34, 53-54
Review of outcomes	
40. FCA, HM Treasury and the Insolvency Service together consider implications of the MF Global judgments:	
a Whether any of the outcomes in the MF Global cases should be codified in the SAR or the applicable Rules.	Pages 21-22, 53-54
b Whether the outcome reflects the collective policy intention at the time the SAR was introduced, or would have done so if the particular fact pattern of which MF Global is representative had been considered at the time.	Pages 21-22, 53-54
c Whether and how best to remove the anomalies in the drafting of the SAR identified by the MF Global decisions.	Pages 21-22, 53-54
d An exercise should be carried out to identify whether there are any other anomalies between client entitlements under CASS and their creditor claims under SAR.	Pages 21-22, 53-54

Recommendation	Page reference
G. Role of the Courts and dispute resolution	
Consider:	
Fast tracking and other proposals	
41. LJ Briggs' recommendations, including fast-tracking determinations of major issues in large insolvencies.	Pages 54-55
Operational implications of issues in dispute	
42. Courts to be given presentations on operational aspects of disputes, practical implications of particular legal outcomes, and so on.	Pages 54-55
Alternative dispute resolution methods	
43. Exploring alternative methods of speeding up reaching determinations of the legal issues which will inevitably arise in complex investment firm insolvencies.	Pages 54-55
FCA power to make determinations	
44. As an alternative to Court, an FCA power to make binding rulings on points unclear or not covered by CASS, in individual cases.	Pages 54-55
Court power to allow payment of Client Asset costs out of Firm Estate	
45. The Courts to be given power, through the SAR, to direct that some Client Asset costs can be paid out of the Firm Estate if the failed firm's conduct prior to failure has resulted in increased costs. Guidelines should be drawn up as to the circumstances where this would be appropriate.	Pages 24-25, 34
H. Some more general recommendations	
Administrator power to top up Client Money shortfalls from firm funds where Client Monies not paid into client accounts prior to the firm's failure.	
46. Where firms use the 'Alternative Approach' to temporarily pay client monies into a general firm account, there should be a mechanism allowing the Administrator to transfer out of credit balances on firm account sums which they consider to reflect the proceeds of payments made by clients, or by third parties for the account of the firm's clients, into a firm account and not transferred into a client account prior to the failure. If this recommendation is adopted, the authorities should consider both whether the Administrator can do this of their own accord, or should require court consent and whether this "top up" principle should have wider application than just where firms adopt the "Alternative Approach".	Pages 25, 31
FCA powers	
47. FCA and Treasury should identify legislative constraints under which FCA works in this area to consider whether to empower FCA to operate a more effective regime to protect Client Assets in going concern mode and also on the failure of an investment firm.	Page 28
Codification	
48. Any codification of CASS Rules should provide an alternative mechanism to the outcomes of Court decisions that are considered unworkable, e.g. by providing a regulatory alternative or substitute to Tracing.	Pages 31, 56
49. Codify the existing CASS regime as now elucidated by LBIE Court judgements.	Page 31
FCA CP 13/5 and Speed Proposal	
50. FCA involves experienced Insolvency Practitioners, in-house Client Asset specialists at investment firms and expert financial services and insolvency lawyers in formulating any rules relating to the FCA's Speed Proposal if introduced.	Pages 30-31

Recommendation	Page reference
51. If the FCA implements 'Speed Proposal', consider mechanism for FCA to "bless" Administrator's conclusion that Speed Proposal can be pursued, as it is reasonable to determine client entitlements from firm records.	Pages 30-31
Buffer	
52. Support use of buffer for insolvency expenses.	Page 31
Segregation/multiple pools	
53. Create regulatory requirement for clear "virtual" segregation in a firm's records between securities purely held on a custody basis and others, such as those which may be charged back to the firm.	Page 57
Fundamental Review of Law	
54. Consider need for radical review of law under which client entitlements can arise in UK Client Asset protection regime, and whether appropriate to rely on property, trust and insolvency law concepts, in context of fast moving and intangible rights of modern and sophisticated investment markets.	Pages 17, 57
Use of Schemes of Arrangement	
55. Consider whether Schemes of Arrangement scope could be expanded to deal with proprietary claims and overseas law governed contracts.	Pages 58
Different regimes	
56. Consider justification for differences between SAR and SRR regimes mechanics and whether any aspects that are needlessly different can be streamlined.	Pages 58-59
57. Produce a guidance note on the factors which are likely to determine which (of the three possible regimes) is selected in any particular case. This might also comment on the respective roles of the FCA and PRA in different cases.	Pages 58-59
FCA/PRA roles	
58. Guidance Note on FCA/PRA Roles in SAR cases.	Page 59
Industry funded compensation scheme	
59. Canvass stakeholder views on more generous industry funded compensation scheme to top up FSCS protection.	Page 36
Non EMIR "porting"	
60. Consider the SAR expressly recognising lawfulness of non EMIR powers of trading exchanges unilaterally to close out and make substitutions (including using failed firm collateral) in respect of client positions if counterparty fails. Alternatively, make clear that such transactions, to the extent they are carried out for market integrity reasons, have protection under Companies Act 1989, Part VII.	Page 60
Cooperation guidance	
61. Update ' <i>Cooperation Guidance Between Recognised Bodies And Insolvency Practitioners To Assist Management Of Member Defaults By Recognised Bodies</i> ' with comments from FCA, professional and trade bodies.	Pages 60-61
Data aggregator	
62. Consider merit of a single aggregator of data which might assist an Administrator, as well as regulatory authorities.	Page 61
Requirement for review	
63. Removal of requirement for review of SAR investment firm insolvency regulations each time the Treasury makes new regulations pursuant to section 233 of the Act. Alternatively, a simple report could be required to be delivered to Parliament rather than a full independent review.	Page 61

Recommendation	Page reference
Title of SAR regulations	
64. Amending the definition in the Act and title of SAR regulations so they do not refer to 'investment banks'.	Page 62
I. Behavioural recommendations	
Note: The following recommendations are reproduced from those previously discussed in my Interim Report on pages 32-33. As a consequence, they are provided again for reference only in Annex B of this report.	
<p>65. Good record-keeping essential: Some firms need to improve quality of records. Practices of reconciliation of firm and client or counterparty records need to be enhanced.</p> <p>66. Clients should be encouraged to review statements received from firms.</p> <p>67. Consider standardisation of the data supplied or notes provided particularly ongoing transactions.</p> <p>68. Firms to make sure clients (especially retail clients) should be able readily to understand contents of client statements, particularly in relation to the status of ongoing trades. Regulators should ensure this.</p> <p>69. Client asset and money rules need to be fully understood by both regulators and regulated.</p> <p>70. Firm's intra-group relations need to be clear and transparent: firms should remove any ambiguities in their intra-group contractual and entitlement arrangements. Regulators should focus on this and consider whether CASS resolution packs for groups should contain copies of the principal long term intra-group agreements.</p> <p>71. Improvements to communications should be considered: FCA, 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. The complexities of the circumstances in which FSCS may be able to provide compensation would be one example.</p> <p>72. 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.</p>	

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Foreword

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

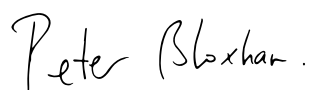
In creating powers for the government to make regulations to deliver this special administration regime, Parliament required that the Treasury hold an independent review of the SAR within two years of it coming into force. I was appointed to undertake this and did so, producing my Interim Report, which was published on 23 April 2013¹ on how well the SAR meets the aims set out for it in the legislation. 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 improve the SAR. Accordingly, I undertook a further review, resulting in this second report.

To this end, I was asked to work closely with the FSA (now the FCA) as it undertakes its own review of its rules for Client Assets (both custody assets and Client Money). I have also worked with the Insolvency Service, the Financial Services Compensation Scheme (FSCS), the Bank of England and clearing houses. Through the good offices of the Treasury and the FCA, I have been able to carry out consultations with a range of market bodies, representative organisations, professionals and other affected parties.

I have had extensive discussions with Administrators involved in the administration of Lehman Brothers International (Europe) Limited (LBIE) and in the SAR cases to date (of which there are now five) and also with lawyers involved in some of the cases which have come to the Courts on the interpretation of the CASS rules, the SAR and the interrelationship between them. I have found that the responses from the consultation process have been generally supportive of the main conclusions and recommendations from my Interim Report.

In this report, I make my recommendations, and also set out my conclusions on further areas I had identified that I have now been able to review in some depth, as part of the second phase of my work.

I am most 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

¹ <https://www.gov.uk/government/publications/review-of-the-special-administration-regime-sar-for-investment-banks>

1

Introduction

1.1 The Banking Act 2009 ('the Act') passed through Parliament in the aftermath of the collapse of the Lehman companies. It contained provisions allowing for the establishment, by secondary legislation, of a bespoke insolvency regime for investment firms¹. This is the SAR. The SAR was established in 2011, as a variant of insolvency law, designed to adapt the UK's general insolvency framework to failures of investment firms, and in particular to facilitate the prompt return of Client Assets. This was done against the background of widespread dismay at the slow return of Client Assets in the LBIE administration. The case for a bespoke system for investment firms reflected the special position of investment firms, which for larger businesses may be particularly complex, and which hold or control substantial quantities of assets belonging to their clients. It was important both to give the Administrator powers to deal with assets which do not belong beneficially to the failed firm and also to impose on them responsibilities to give Priority to returning or transferring those assets.²

1.2 The SAR applies to all investment firms. However, to the extent that a failure would have a 'systemic' impact on the UK's financial system, the Special Resolution Regime³ for systemic investment firms has also been put in place by the Financial Services Act 2012.

1.3 The SAR regime was developed in collaboration with an advisory panel of industry experts, taking account of responses from consultations. It introduced a mechanism to modify insolvency principles in the administration of a failed firm holding or controlling assets belonging to its clients. In particular it:

- 1 Gives the Administrator jurisdiction over the distribution or transfer of those assets;
- 2 Requires the Administrator to Prioritise dealing with those assets;
- 3 Imposes on the Administrator and certain third parties duties designed to facilitate the identification, collection and transfer or return of Client Assets;
- 4 Establishes certain continuity of supply rights for the benefit of the Administrator in relation to key services;
- 5 Allows for the use of a Bar Date mechanism in connection with distributions (currently limited to non cash Client Assets); and ⁴

¹ I refer to 'investment firm' to mean 'investment bank' as it is defined in s.232 of the Act (where it has a very specific legal meaning which is perhaps more akin to an investment firm).

² Without the SAR, an Administrator would have to go to Court for confirmation of their standing to deal with Client Assets and would not be able to Prioritise the transfer or return of Client Assets.

³ The SRR within the meaning of s.258A of the Act.

⁴ Unless the SAR rules modified them, the normal principles and rules relating to administrations and the conduct of Administrators apply. There are special rules within the SAR for investment firms which are also deposit takers (for example, banks). No such firm has yet gone into the SAR, so those procedures have not been tested.

- 6 Including some provisions (currently limited in scope, as discussed in Chapter 4) concerning the rights of clients to submit claims as creditors in the distribution of the general estate of the failed firm.

1.4 In return for allowing the use of secondary, rather than primary, legislation for the creation of the SAR, the Act required an independent review to be carried out within two years of the coming into force of the SAR. The Act specified certain matters to be covered by the review, including whether the SAR was meeting the objectives set for it in the Act and whether the SAR should continue in effect.

1.5 The Treasury appointed me to carry out that independent review.

1.6 The second anniversary of the SAR coming into force fell on 7 February 2013 and I submitted my Interim Report to the Treasury by that date⁵. It was subsequently published in April. The Interim Report addressed the statutory requirement to consider whether and to what extent the SAR met the objectives set for it in the Act and whether the SAR should continue in force.

1.7 In drawing up the Terms of Reference for the review, the Treasury sensibly decided to enlarge the scope of the review and to split it into two stages, the first meeting the Parliamentary timetable and the second allowing a longer period for consultation and more detailed consideration of the issues, as well as making definitive recommendations. This is the report of the second phase of the SAR review.

1.8 My work has proceeded in tandem with the work the FCA has been doing to consider and consult on reforms of its CASS rules, culminating in the issue of its consultation paper CP 13/5 entitled 'Review of the Client Assets regime for investment firms' ('FCA CP 13/5') in July of this year. I have, as required by the Terms of Reference, worked closely with the FCA throughout both stages of the review.

1.9 Having concluded that the SAR should continue in force, I have concentrated, for the purposes of this second report, on identifying the definitive recommendations to make for the reform of the SAR.

1.10 In considering what might be improved, I have taken into account the underlying legislative objectives of protecting Client Assets and creditors' rights, ensuring certainty, minimising disruption, and maximising efficiency and effectiveness of the UK financial services industry.

1.11 We inevitably learn much from when a regime is tested. Since its inception, five firms have entered the SAR – MF Global UK Limited, Pritchard Stockbrokers Limited, WorldSpreads Limited, Fyshe Horton Finney Limited and, most recently, City Equities Limited. (See Chapter 2). None of these insolvency procedures is yet complete. In the case of MF Global – the biggest and most complex case within the SAR – there was concern that Client Money may not have been returned as quickly or to the same extent as in the United States. I have therefore considered whether concerns that the SAR has not delivered the desired results in terms of improving speed, rate of return, costs of process, and maintaining the UK's competitive position are justified, and what might be recommended. My Interim Report recognised the inherent causes of the perceived slow process and that the SAR was never intended to be a panacea.

1.12 The outcome of the LBIE litigation has heightened the need to ensure a holistic approach between regulation in going concern mode and the operation of the SAR in 'gone concern' mode. It is clearly important to ensure there is one, rather than a dual, regime with conflicting

⁵ Review of the Investment Bank Special Administration Regulations 2011:
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/190983/peter_bloxham_review_of_investment_bank_sar2011_.pdf

goals, and the following chapters consider this further. This unitary approach is clearly recognised by the FCA in the FCA CP 13/5. (See Chapter 6).

1.13 Inevitably, there will be a need to reconsider the regime as new developments occur. In this connection, I note that the FCA have tabled proposals within their FCA CP 13/5 which consider a case for a more radical overhaul of the regime as well as setting out comprehensive amendments to the Client Asset Sourcebook ('CASS'). I set out in Chapter 6 my thoughts on the former, and suggest any further work that HM Treasury might consider to deliver any further assessment of options in Chapter 8.

1.14 The protections for Client Assets (including money) in CASS are based on English property and trust law and the framework of the SAR reflects this. A persuasive case has been made that it is time to carry out a review of whether trust law and associated property law concepts are best adapted to protection of clients' interests in the financial markets. This strays outside my Terms of Reference, but in view of the importance of the principles involved, I make some general comments about this in Chapter 3.

1.15 The two stage process of my review has given me a chance to engage at a deeper level with a cross section of relevant parties. I have had extensive discussions with the Administrators of LBIE and of most of the SAR cases and also with some of their advisers. I have been able to gain the views of the Bank of England, the Insolvency Service and the FSCS. I have had a number of meetings with other interested professionals and representative bodies. In addition to having numerous meetings with the FCA, I was able to sit in on a number of forums organised by the FCA to canvass views on topics being considered for the purposes of the FCA CP 13/5. These have all been extremely useful.

1.16 The outcome of the consultations I have been able to carry out is that, although there is understandable frustration with the complexity and delays that have occurred in some of the cases, I have not received any strong opinions that the SAR should be dispensed with. A wide range of reform proposals have been discussed and many of these are reflected in my recommendations in this report.

Summary of conclusions

1.17 This review concentrates on the recommendations I am making to the Treasury for the improvement of the SAR. It builds on my earlier report and contains my final recommendations that I suggest implementing in the future. I do not repeat all the other findings of the Interim Report, and, except where otherwise stated, I maintain the views and recommendations expressed in the Interim Report.

1.18 I consider that:

- 1 The SAR has a useful function when a non-systemic investment firm fails and that it should be retained;
- 2 One has to be realistic about the extent to which any insolvency regime can rapidly resolve the problems which are bound to arise if an investment firm of any complexity fails;
- 3 Clear and comprehensive rules relating to the status and segregation of Client Assets, as well as good quality and up to date record keeping, are as important to a rapid return or transfer of Client Assets as the SAR regime itself;
- 4 There are improvements which can and should be made to the SAR. These include actions to clarify the interaction of CASS and the SAR, in the light of experience to

date. In particular, the SAR needs comprehensive revision so that the Bar Date mechanism applies both to Client Assets and to Client Money and that it deals fully and consistently with claims in the Firm Estate related to a client's Client Money (as distinct from other Client Assets) entitlement. I discuss this further in Chapters 3 and 4.

- 5 There are some further enhancements which could be made to the FSCS compensation regime, building on changes already made;
- 6 The FCA should consider whether the FSCS compensation arrangements in relation to portfolio transfers could be extended to cover shortfalls in Custody Assets (provided they fall within the scope of FSCS protection) in addition (as they now do) to Client Money shortfalls;
- 7 Consideration should be given to identifying alternative methods of speeding up reaching determinations of the legal issues which will inevitably arise in complex investment firm insolvencies; and
- 8 The entire regime for protecting Client Assets and efficiently returning or transferring them if a firm fails should be kept under regular review, so that the regimes continue to be well adapted to changing products and market and operating practices.

My suggested priorities

1.19 My Summary of all Recommendations is set out before this Introduction. If looking to prioritise these in order of importance, I would highlight the need to (a) facilitate transfers; (b) make amendments to the Bar Date; (c) review and expand the SAR provisions associated with a client's claims against the failed firm arising out of Client Money⁶ and (d) consider enhancements to the FSCS regime. (See Chapter 8).

1.20 The results of my investigations and my reasoning are contained in the remaining chapters of this Report.

⁶ In particular, recommendations 10, 11 and 13.

2

Developments since the SAR was introduced

2.1 It may be useful to summarise a number of developments which have already taken place and which provide some context for my review. Since the failure of the Lehman entities and the SAR was introduced, there have been five investment firms entering the SAR (Part I); and a number of legislative and regulatory developments (Part II). I summarise these in this chapter.

Part I: Five SARs

2.2 Since the SAR was introduced, five firms have gone into the procedure. These are:

- 1 MF Global UK Limited
- 2 Worldspreads Limited
- 3 Pritchards Stockbrokers Limited
- 4 Fyshe Horton Finney Limited
- 5 City Equities Limited

2.3 Whilst none of the five cases mentioned above have been completed, it may be noted that none of them have had the complexity of LBIE. It is also worth noting that not every investment firm failure since the SAR was introduced has been a SAR case. One at least, Seymour Pierce Group Plc, went into an “ordinary” administration. This remains an option for failed investment firms, as the SAR is not a mandatory procedure.

2.4 A few comments are set out below on these cases:

MF Global UK Limited

2.5 MF Global UK was the European arm of the MF Global Group, acting principally as an intermediary broker for exchange traded and over the counter derivatives as well as for foreign exchange products and securities. It went into administration on 31 October 2011.

2.6 MF Global is by far the largest of the SAR cases and the SAR procedure which has thrown up the greatest number of issues to be considered by the Courts.

2.7 As at October 2013, following the effective resolution of intra-group claims, approximately 90 per cent of Custody Assets and 70 per cent of the value of agreed Client Money claims will have been distributed.

2.8 The failures of the MF Global companies, like LBIE, have involved procedures on both sides of the Atlantic and have therefore provided some opportunity for comparison of regimes. A more detailed discussion of some of the SAR-related issues which have had to be resolved in the MF Global case can be found in Chapter 4.

Worldspreads Limited

2.9 Worldspreads was essentially a spread betting company, which went into the SAR on 18 March 2012. It had a mainly retail client base.

2.10 There is at present a substantial shortfall in Client Monies which the Administrators are investigating. Information that I have received indicates that distributions of at least 8 per cent of the total value of agreed Client Money claims have been made.

2.11 There was a relatively small holding of Custody Assets (i.e. Client Assets other than Client Money). This was held by a third party and is expected to be returned to clients, substantially covering all custody asset claims.

Pritchards Stockbrokers Limited

2.12 Pritchards was a regional stockbroker with a predominantly retail client base. It went into the SAR on 9 March 2012. Shortly before going into administration, it agreed to transfer the bulk of its client portfolio to another stockbroker, WH Ireland Group Plc. This should have resulted in Pritchards holding or controlling few if any Custody Assets when it went into the SAR. However, a substantial reconciliation exercise has been required which will have delayed clients getting access to all their Custody Assets. There are likely to be some small shortfalls, which in many cases will be covered by FSCS compensation.

2.13 The Administrators began paying out agreed Client Money claims, at a distribution rate of 50 per cent, four months after appointment. This process has continued.

Fyshe Horton Finney Limited

2.14 This firm went into SAR on 20 March 2013. Fyshe Horton Finney was also a private client stockbroker. The Administrators were able to transfer the private client portfolio at an early stage.

2.15 FSCS has already paid compensation to those clients with an agreed balance of less than £50,000. It is in the course of processing claims received from other eligible clients.

City Equities Limited

2.15.1 Just as this report was being finalised, a fifth firm went into the SAR. This is City Equities Limited, a London based stockbroker which went into SAR on 11 October 2013. The timing has meant that it has not been possible to determine if there are any further lessons to learn from the case.

Table 2.A: Simplified summary of outcomes to date in the first four SAR cases

Company	Return of Client Assets (other than Client Monies)	Return of Client Monies)	Return to ordinary non client creditors	Client Monies shortfall for clients: current estimate
M F Global UK	90%	65-70%	0-5%	15-20%
Worldspreads	99%	8%	0-5%	91% (due to cash shortfalls – depends on litigation outcome, etc).
Pritchards	substantially all	50%	uncertain	shortfall of £3 million out of £26 million
Fyshe Horton Finney	100%	66%	uncertain	5%

Conclusions

2.16 I have sought to determine what, if any, conclusions to draw about the SAR from these outcomes. The differences of outcome (at least to date) in respect of Custody Assets and Client

Monies in each case is very marked, although there are likely to be different contributing factors in each situation. The time taken for clients to receive a return of their assets, especially Client Money, and the associated costs, means that there is no room for complacency, even though each particular failure has had its own reasons for delays, notably complexities of intra-group arrangements, problems of reconciling records and taking account of last minute status changes, shortfalls of assets or cash and difficulties in achieving or perfecting portfolio transfers. MF Global has also thrown up potential frictions between CASS and SAR which have needed to be clarified and resolved (as mentioned in Chapter 4).

2.17 However the SAR will have been of some value in all of these cases, if only because of its co-operation and continuity of supply provisions. A SAR modified in line with recommendations in this report would potentially have been of greater value in at least some of the cases, notably by facilitating the transfer of portfolios and clarifying the interrelationship between clients' CASS and SAR claims.

Part II: Regime developments to date

2.18 Since the failure of the Lehman entities and the SAR was introduced, there have been a number of legislative and regulatory developments relating to investment firms and Client Assets. Of these, some of the more significant developments are set out below:

- 1 The multiple legal decisions in LBIE and MF Global that have clarified both the interaction of CASS and SAR (or insolvency law more generally) and the meaning and effect of a number of particular CASS and SAR Rules;
- 2 The Financial Services Act 2012 (now mainly in force) has established a mechanism, built on that in the Act for banks, to enable the resolution of 'systemic' investment firms, i.e. those whose failure would bring an unacceptable risk to the viability of the wider financial system;
- 3 The FCA have taken action to ensure that firms place more emphasis on protecting Client Assets and have augmented their own monitoring resources;
- 4 There have been other regulatory initiatives such as the establishment of the CASS operational oversight function (CF 10a)¹ and the requirement for firms to produce, and keep updated, CASS Resolution Packs²;
- 5 The FCA has issued the FCA CP 13/5, with its proposals for reform of the regime relating to Custody Assets and Client Monies;
- 6 The FSA had previously consulted (CP 12/22) on its CASS rules and invited views on a number of matters, including Client Money sub pools;
- 7 Measures have been taken to streamline the FSCS procedures for paying compensation where investment firms fail;
- 8 Cases have been decided by the Courts on the International Swaps and Derivatives Association standard documentation, particularly in relation to the legal consequences of the 'suspensory' provisions for the benefit of non defaulting parties. These may reduce the incentive for non-defaulting parties to defer taking decisions as to what, if any, remedies to exercise as a result of the failure of the investment firm. Such delays can impact on the conduct of the administration

¹ See CASS 1A.3.1A and SUP 10A.7.9R, available at: <http://fshandbook.info/FS/html/handbook/CASS/1A/3>

² See CASS 10, available at: <http://fshandbook.info/FS/html/handbook/CASS/10>

generally, as it holds up computation of net positions (and client shortfalls) between the failed firm and its clients;

- 9 IOSCO³ has been working on recommendations for standards applicable to Client Assets;
- 10 EMIR entered into force on 16 August 2012. Whilst some provisions do not yet apply, many of its regulatory technical standards do. It introduces new requirements to improve transparency and help mitigate systemic risk in the derivatives market. It also establishes common organisational, conduct of business and prudential standards for central counterparties (CCPs) and trade repositories;
- 11 Most significantly for our purposes, EMIR contains 'porting provisions', under which, in the event of the clearing member's default (such as an investment firm), a CCP must attempt to port any client positions and associated margin held by a CCP to another, solvent clearing member i.e. a backup clearing member. Where porting fails for any reason, any balance owed by the CCP is to be returned directly to clients or to the clearing member for the account of its clients; and
- 12 At a practical level, the occurrence of some major investment firm failures has created a pool of expertise in the professionals community about some of the particular complexities involved in handling such cases.

Conclusions

2.19 It is to be hoped that these, together with whatever revised CASS regime results from the FCA CP 13/5 and the reforms of the SAR I am proposing, will by themselves tend towards facilitating a more rapid and efficient return or transfer of Client Assets, achieved at lower costs, and (where applicable) swifter payment of compensation in any future investment firm failures. Nevertheless, some practical problems are likely to be inevitable in (particularly major) investment firm failures.

2.20 The recommendations in this Report are designed to build on the reforms and initiatives already instituted, and to be consistent with those currently under consideration.

³ IOSCO consultation report CR 02/13 'Recommendations regarding the protection of Client Assets'.

3

The SAR in context: interrelationship between CASS and SAR

3.1 It is essential that the FCA’s CASS Rules and the SAR regulations should work together effectively and, in particular, that there should be no unnecessary gaps or conflicts. The policies underlying CASS and SAR need to be consistent. An essential prerequisite for the SAR is that it needs to be designed so as to facilitate the operation of CASS and in particular the CASS distribution arrangements when an investment firm fails.

3.2 It is just as important that there be clarity as to where the CASS Rules apply and where SAR or other general insolvency law principles determine client entitlements, outcomes and distributions to clients.

3.3 The CASS Rules apply to regulate how a firm in going-concern mode protects its Clients’ Assets (including money). In addition, the CASS Rules also provide a regime for the distribution of Client Money on a firm failure. The CASS regime deals separately with “Custody Assets” held or controlled by a firm for the account of its clients and Client money. Custody Assets must be segregated and, although there is no express trust over them, it is generally considered that the investment firm has no beneficial interest in them. Under the CASS Rules, a statutory trust arises when the firm receives Client Money, with it deemed to be a trustee for the client. In gone-concern mode, the SAR enables the Administrator to step in as trustee, and to handle Client Assets in line with CASS.

3.4 Thus it can be seen that Client Asset protection derives essentially from the FCA’s Client Assets regime (which incorporates the MiFID requirements). It is that which requires Client Asset segregation and establishes the statutory trust over Client Money. These requirements, and the protection they provide, continue to apply when a firm fails, supplemented by the FCA rules specifically applicable to the effect of Primary Pooling Events.

3.5 The fact that clients’ assets are protected by the CASS regime and not the SAR may not always have been completely clear. It is notable that, in a number of cases before the Courts in LBIE and MF Global, a central issue was whether the applicable regime for the purposes of determining clients’ rights (or making computations) was CASS or insolvency law. It is now evident that, insofar as matters relate to the handling and distribution of Client Monies, the Courts start from the presumption that the CASS Rules are intended to operate as a comprehensive and autonomous regime for the distribution of the Client Money of a failed firm, largely unaffected by the special insolvency rules in SAR¹. I share the view that it makes sense for all the Client Asset protections (other than the compensation provided by FSCS, or the special porting rules introduced by EMIR) to be in a single body of regulation, rather than split between CASS and SAR or other bodies of insolvency law. It follows that it is essential that the CASS Rules should be a complete statement of clients’ rights as clients, so far as possible.

3.6 An examination of the SAR regulations illustrates the pre-eminence of the CASS Rules as the source of clients’ entitlements when a firm fails. Substantive provisions dealing with clients or

¹ SAR steps in to address how shortfalls (allocated in accordance with CASS) are dealt with in the insolvent estate.

Client Assets are fairly limited in the SAR, and mainly restricted to legislating for the overlap of client and non-client claims, or dealing with shortfalls. One (perhaps the most important) example of a SAR provision which confers substantive rights on clients of a failed firm is the express “shortfall claim” provision for custody assets², which is discussed in more detail in the context of MF Global. (See Chapter 4, paragraph 4.11).

3.7 The SAR is essentially a mechanism to adapt general principles applicable in any administration to the requirements of a failed firm which holds or controls assets belonging to its clients, notably by:

- 1 Giving the Administrator jurisdiction over the distribution or transfer of the assets, which do not form part of the firm’s general estate;
- 2 Requiring the Administrator to Prioritise dealing with those assets;
- 3 Imposing on the Administrator and certain third parties duties designed to facilitate the identification, collection and transfer or return of Client Assets;
- 4 Establishing certain continuity of supply rights for the benefit of the Administrator in relation to key services;
- 5 Allowing for the use of a Bar Date mechanism in connection with distributions (currently limited to non cash Client Assets); and
- 6 Including some provisions (currently limited in scope, as discussed in Chapter 4) concerning the rights of clients to submit claims as creditors in the distribution of the general estate of the failed firm.

3.8 In my view, those who drafted the SAR recognised that the SAR did not need itself to spell out the core client protections, because these derived from CASS or general law.³

3.9 To take a simple but fundamental example, there is nothing in the SAR which states that ordinary non-client creditors of the failed firm have no claim on the assets (including monies) of the failed firm’s clients. This is because there is no need for such a provision. By reason of the statutory trust created within the CASS regime, the firm and its ordinary creditors have no interest in Client Money⁴. Similarly, the investment firm has no beneficial interest in Custody Assets.

3.10 It follows that when an investment firm goes into the SAR procedure, the Administrator takes charge of an entity with two pools of assets:

- 1 The Custody Asset and Client Money pool together (‘Client Pool’);⁵ and
- 2 The assets owned by the firm beneficially (‘Firm Estate’).⁶

3.11 The failed firm and therefore its ordinary creditors, has no interest in the Client Pool, except possibly in the recovery of any unused buffer after full distribution of Client Monies to all clients. Rights to the Client Pool are determined almost exclusively by the applicable CASS Rules, as interpreted by the Courts. Where the CASS regime does not provide for a particular eventuality, the Courts will apply general principles of property or insolvency law.

² Regulation 12(7) of the SAR.

³ Similarly, CASS 6, in relation to Custody Assets (excluding money) does not need to spell out that the firm does not generally have any interest in Custody Assets.

⁴ See sections 137B FSMA and CASS 7.7 in relation to Client Money statutory trust.

⁵ Technically, the Client Pool has two components, Client Monies and other Custody Assets. The CASS distribution mechanisms in CASS 7A apply to Client Money.

⁶ For simplicity, it is assumed that there are no secured creditors.

3.12 The Administrator’s task, in relation to distributions, is therefore to supervise two separate mechanisms:

- 1 Distribution of the Client Pool to clients in accordance with applicable CASS Rules (and where there is a gap, general property or insolvency law), paying the associated costs out of the Client Pool; and
- 2 Distribution of the Firm Estate on a pari passu basis in accordance with the SAR and insolvency law generally to all unsecured creditors.

3.13 The liabilities of the firm (payable exclusively out of the Firm Estate, on a pari passu basis with unsecured and non preferential claims of ordinary creditors of the failed firm) will include claims from clients for shortfalls in the Client Pool as well as certain other contractual rights the client may have.⁷

3.14 In other words, in relation to a failed firm’s clients, the SAR only deals with their position as creditors of the firm, with claims on the Firm Estate. The SAR establishes rules on the client’s position as creditor but not in its capacity as a client claiming from the Client Pool. However, those rules do not currently extend to addressing what happens where there is a shortfall arising from a claim of Client Money (as opposed to a shortfall in custody assets.) This is a gap.

More radical reform of the Client Asset protection regime

3.15 During the course of my discussions with interested parties, a number of different experts, notably from within the legal profession, forcefully made the point that a fundamental problem with the UK Client Asset Protection Regime is its reliance on general English property and trust law concepts, which are increasingly difficult to apply to the fast moving and intangible rights typically the subject of modern and sophisticated investment markets. The most commonly cited example is the doctrine of Tracing, but others (such as the varieties of set off) exist.

3.16 One of the objectives for the SAR in the Act is to maximise the efficiency and effectiveness of the financial services industry in the United Kingdom. I consider that in view of this clear and understandable policy objective, it makes sense to listen to those who take the view that a more radical review should be undertaken of the legal basis under which client entitlements can arise and in particular whether trust and property law concepts are still well enough adapted to interests in products in the financial markets. This should be done on the basis of a very specific call for evidence. It may also require a preliminary investigation of what flexibility there is under mandatory European law to move to a radically different regime.

3.17 The discrete recommendations that follow from the issues raised in this Chapter are set out in Chapter 8 at paragraph 8.22 and subsequent paragraphs.

⁷ I note that the litigation relating to the failure of MF Global has thrown up a number of issues in relation to the interrelationship between a client’s rights in relation to Custody Assets and as beneficiary of the statutory trust and his contractual and other claims against the estate of the failed firm. These cases have revealed some gaps in the SAR regime. I make some observations and recommendations in relation to this in Chapter 4.

4

Points arising from MF Global

4.1 The previous chapter set out, at a conceptual level, how the CASS and SAR regimes should interact. Some MF Global Court decisions have, however, revealed a number of practical problems arising out of the current drafting of the SAR. In particular:

- 1 Complications arise because clients have parallel claims, arising out of the same relationship and transactions, both as clients (in respect of client monies, to the Client Pool) and as creditors with claims in the Firm Estate; moreover, those claims may be valued differently for CASS and SAR purposes;
- 2 SAR treats a client's claim as a creditor in respect of Client Assets differently from the client's claim as a creditor in respect of client monies. I have not been able to discover why this is the case.

4.2 Cases in the UK MF Global SAR have highlighted the potentially complex interplay between a client's entitlements to the Client Money Pool (CMP) under the CASS statutory trust and their claims as a creditor of the failed firm.¹

4.3 The starting point is that a client of a failed firm in SAR has a dual status:

- 1 one, pursuant to and calculated in accordance with CASS, to a share of the CMP, as a beneficiary of the statutory trust established pursuant to CASS (CMP Entitlement), together with an unsecured claim on the general estate for any breach of trust which results in a shortfall in distributions from the CMP (Shortfall Claim); and
- 2 a "parallel" claim under contract (or for breach of contract) on the general estate (Parallel Claim), as an ordinary unsecured creditor of the failed firm.

4.4 These claims will overlap.

4.5 A further complication is that these two rights are valued on different bases, as follows:

- 1 The CMP Entitlement is based on a notional calculation carried out as at the date of the Primary Pooling Event, assuming a close out of client positions on or very close to that date.
- 2 The Parallel Claim will be computed in accordance with general insolvency principles, including application of the "Hindsight" Principle.

4.6 So a client's CMP Entitlement may be higher or lower than their Parallel Claim. Both derive from the same relationship and transactions. Conceptually, it would have been possible to structure the regulatory regime so that the CMP Entitlement was limited to providing protection for the client's ultimate Parallel Claim (and no more). However, one of the MF Global cases has

¹ Case references: [2013] EWHC 92(Ch) and [2013] EWHC 2556(Ch). I understand that MF Global acted principally as an intermediary broker for exchange traded and over the counter derivatives. As a result, most clients' claims over client money related to contractually based investments (as opposed to securities). It is possible that future judgments could distinguish the MFG cases on this basis.

established that the CMP Entitlement is a standalone substantive right and not therefore simply “security” for the client’s Parallel Claim.

4.7 In addition to the complex interplay between a client’s entitlements, both CASS and SAR were revealed to have deficiencies in their drafting during the course of the MF Global cases before the English Courts. Points which needed to be addressed by the Administrators were not covered by either the CASS or SAR. Nor was it always clear how the two regimes were expected to operate with each other. It has fallen to the Courts to seek to ascertain how the two regimes should apply to the circumstances which arose in MF Global. This has caused delay in terms of achieving SAR Objective 1 (return of Client Assets to clients) and has increased the costs of the administration, some of which will have fallen on clients.

4.8 I can see that there are practical reasons for the notional calculation used for computation of the CMP Entitlement, notably achieving uniformity between clients and allowing an early computation of entitlements, leading potentially to a more rapid return of Client Money to clients. However, the use of a notional value for the CMP Entitlement means that there will almost always be a divergence between the value of claims against the CMP and the value of assets in the CMP, as the notional values of claims for open positions will not generally reflect the value subsequently generated for the CMP by those open positions upon close out.

4.9 The Parallel Claim is likely to be a more accurate reflection of the client’s actual loss, as eventually established.

4.10 The difference between calculations of the CMP Entitlement and the Parallel Claim throws up anomalies.

4.11 Neither CASS nor the SAR spells out the detailed interaction between the two regimes. The SAR does expressly recognise² that, where a client receives from the firm less than 100 per cent of their client Custody Assets (i.e. not extending to Client Money), they have an unsecured claim against the failed firm. This is a claim created by the terms of the SAR, but applies only to Client Assets which are not Client Money, so it does not apply to shortfalls in the CMP. The SAR does not provide any guidance as to how to compute an unsecured claim against the firm arising from a shortfall in the CMP. There does not appear to be any good reason for this. According to the most recent MF Global Court judgement³, a client’s Shortfall Claim (for Client Money) is only provable if and to the extent that, when added to the actual and prospective distributions made to the client from the CMP, it exceeds the amount of the Parallel Claim. This means that in certain circumstances a client with a Client Money entitlement can recover from the firm’s general estate more than the contractual value of their claim. In a case of a shortfall in assets of the failed firm, this could be at the expense of reduced returns for other clients and unsecured creditors. I consider that this is unfair.

4.12 The overall outcome of the MF Global decisions creates a very complex result and one which has required some judicial ingenuity. It places a considerable additional burden on the Administrators in order to carry out the investigations and calculations required to identify any breaches of trust and to calculate the resultant losses and, therefore, the value of any Shortfall Claims.

4.13 There is no express mention in the SAR of a Parallel Claim and this leads me to wonder whether it was fully taken into account in the drafting of the SAR.

² Regulation 12(7) of the SAR

³ See footnote 1 in this Chapter.

4.14 Furthermore, a degree of confusion and complexity is created as a result of the terminology used in the SAR in referring to, and therefore providing for, the treatment of clients' claims on the general estate linked to, Client Assets. In various places the terms used are expressed to include Client Money and in other places Client Money is excluded. This may (at least in some places) have been deliberate at the time in the context of the Bar Date. However, I consider that the time has come to rationalise treatment of claims related to Client Money for the purpose of the SAR, with a view to harmonising SAR claims in respect of Client Money and Custody Assets, except to the extent that there is a compelling policy reason to maintain the distinction in treatment. I have been unable to discern what justification there might be.

4.15 The decision in this case came after I had concluded my consultations, so I have been unable to canvass views widely.

4.16 It seems to me that the CMP ought, as a matter of principle, to protect no more and no less than a client's contractual entitlement, as eventually determined. If that principle is accepted, the SAR should give effect, in an administration, to the policy of the CASS. Nevertheless, as mentioned above, I can see the practical sense of using a notional valuation date for CMP Entitlement purposes, in order to ensure fairness among the client community and to accelerate the return of client monies. Those factors may justify a return to clients from the CMP which does not ultimately reflect the "true" loss each client suffers, and which ultimately produces differential "real" shortfalls for different clients. Consideration should be given to seeking to adopt a system of valuation for CMP Entitlement purposes which is more likely to reflect the value of assets in the CMP, by using the hindsight value rather than a notional mark to market value.

4.17 Furthermore, I can see that it is likely, in cases where there is a CMP shortfall, that the aggregate return to clients (from CMP and the Firm Estate taken together) will be higher than for non-client creditors (because of the existence of the segregated and dedicated CMP, even if there is a shortfall in it).

4.18 Insolvency procedures are more focussed on fairness between creditors and, as I noted in the Interim Report, the Act requires the SAR (and therefore the Administrator) to protect (non client) creditor interests.

4.19 I have given thought to what recommendations to make in the light of MF Global and also on its impact on my recommendations. These are set out below.

- 1 In view of the fact that the most recent MF Global decision only came out at the end of my review (and after publication of the FCA CP 13/5), a fuller consideration of its implications by FCA, HM Treasury and the Insolvency Service may be called for. In particular, it is important for those bodies to consider whether the outcome reflects the collective policy intention at the time the SAR was introduced, or would have done so if the particular fact pattern of which MF Global is representative had been considered at the time.
- 2 In this connection, I note that the FCA (whose consultation document CP 13/5 was published before the most recent MF Global decision was handed down) has proposed a limited introduction of hindsight to the CMP Entitlement computations⁴. If this proposal proves to be workable, it may be that some at least of the anomalies I have described above could be removed by a broader adoption of hindsight for CMP entitlement purposes. I therefore recommend that the FCA

⁴ Paragraphs 2.44- 2.49. These paragraphs also contain the FCA's reasons for limiting the proposal to introduce the Hindsight Principle to certain categories of transaction.

reviews whether, consistent with the objectives of fairness between clients and rapid return of cash, hindsight could be introduced more widely for CMP Entitlement purposes. At the risk of introducing excessive amounts of complication into the CMP regime, a mechanism might be introduced into the CASS trust for making adjustments if the CMP is distributed in instalments.

- 3 The SAR needs to be modified to include a comprehensive statement of the basis on which clients who make recoveries pursuant to their CMP Entitlement are entitled to make claims in the administration, covering both the Parallel Claim, its interrelationship with the CMP Entitlement, the Shortfall Claim and the position in relation to shortfalls of Client Money, not just non-cash/Custody Assets.
- 4 The SAR should provide guidance on how costs borne by the failed firm's general estate and costs borne by the firm's Client Money estate should be apportioned.
- 5 Generally, I consider that the Treasury, FCA and the Insolvency Service should work together to see whether and how best to remove the anomalies thrown up by the drafting of the SAR and the MF Global decisions.

4.20 The discrete recommendations that flow from this Chapter are also summarised set out in Chapter 8 in Section C and at paragraphs 8.81-83.

5

Some particular issues raised in consultation

5.1 During the course of my review, a number of topics came up on a regular basis. For that reason I thought it right to discuss some of them in more detail and to explain the reasons for reaching the conclusions I have arrived at, in particular where these do not feature substantially in Chapter 8 that sets out my recommendations.

5.2 In this connection, I note that the Terms of Reference expressly require that the Report should be evidence based.

Administrator immunity in SAR cases

5.3 Certain constituencies consider that in investment firm administrations (SAR and non SAR) to date, the Administrators have exercised an undue degree of caution in carrying out investigation, reconciliation or other work before returning Client Assets and that the reason for this caution is the existence of a degree of personal liability on the part of Administrators. The conclusion drawn is that, if SAR Administrators benefitted from immunity, returns of Client Assets could be expected to be accelerated.

5.4 Personal exposure may not in fact be the only reason for any perceived caution. More rapid progress with agreeing client claims and distributions may prove to be at the expense of non client creditors and, as mentioned in the Interim Report, one of the challenges facing an Administrator under the SAR is to prioritise dealing with Client Assets without giving clients any preference.

5.5 It is not immediately clear why a SAR Administrator should be subject to lower standards than an ordinary Administrator or, conversely, why the unsecured creditors of a failed firm in a SAR administration should enjoy a weaker degree of protection.

5.6 In the wider sphere of administration, the threat of personal liability does not appear to prevent Administrators acting swiftly; the continuing debate about 'pre-pack' administrations reflects a concern that Administrators may act too hastily or without adequate external marketing in disposing of businesses which go into administration.¹

5.7 In talking to Administrators in SAR and non SAR cases, I have not been persuaded that delays in return of Client Assets have been, to any appreciable extent, attributable to the lack of immunity for the Administrators. Rather, the key factors appear to have been some combination of the following factors:

- 1 The need for some period of familiarisation with the affairs of the failed firm;
- 2 The need to clarify the operation and effect of the Client Asset and SAR regimes;
- 3 The state of the records of the failed firm;

¹ The term "prepack" is used to denote a case where a company in trouble negotiates a possible sale of its business before entering into administration, then goes into administration and the Administrator (who may have been following the negotiations prior to his appointment) is invited shortly after his appointment to effect the sale transaction without any further marketing exercise. Independent valuation advice will generally be available to the Administrator so as to support the transaction.

- 4 The need to carry out and agree reconciliations;
- 5 Litigation, often involving officeholders of other group members; and
- 6 Delays in securing the return of Client Assets and Client Monies held by third parties.

5.8 I have not detected any strength of appetite among the Administrator community for immunity in SAR cases. As one of the Administrators has put it to me, Administrators will always want to do the right thing, whatever the regime. Most of the Administrators I have spoken to have indicated that they do not consider that Administrator immunity would have any significant impact on efficient and speedy return of assets to clients, and in fact are not supportive of it. In any event, it is doubtful whether any immunity arrangements that are likely to be under contemplation would be so protective as to remove the threat of claims, however tactical, from those with an interest in arguing for an outcome different from that proposed by, or mandated on, the Administrator in any particular case.² Insolvency law does of course already provide mechanisms for an aggrieved creditor to challenge the conduct of an Administrator.³ As soon as any immunity is subject to limits, any risk of “undue caution” survives, because the supposedly nervous Administrator may be threatened with, or fearful of, allegations that their proposed conduct is outside the scope of their immunity.

5.9 I would add that the SAR (paragraph 10 (4)) contains an explicit requirement for the Administrator to “... work to achieve each objective, in accordance with the Priority afforded to the objective... as quickly and efficiently as is reasonably practicable.” This bolsters the existing remedy available in all administrations under paragraph 74(2) of Schedule B1 to the Insolvency Act 1986. So it is not open to the Administrator to allow excessive prudence to delay the return of Client Assets.

5.10 In circumstances where there is little support from those who would most immediately benefit from an immunity regime, or evidence as to the improvement in outcome for clients, I remain reluctant to advocate such a radical change in the status and responsibilities of Administrators when they are working in this particular sphere of insolvency.

5.11 Finally, it may be worth mentioning that, so far as I can tell, there is no specific immunity for the equivalent office holder in comparable cases under US law⁴. Clearly that has not precluded rapid transfers of portfolios of Client Assets. I recognise that Court approval of such transactions will provide a considerable degree of practical comfort to the officeholder in US cases.

5.12 In the Interim Report (paragraph 5.25), I included modest proposals to provide Administrators with a limited degree of immunity in two specific areas, which I continue to support. See Chapter 8.

5.13 Finally, if a decision is taken to adopt the Speed Proposal in the FCA CP 13/5, it seems to me that, in order for that process to be workable, there would need to be a mechanism whereby the decision of the Administrator to adopt the Speed Proposal and rely on the failed firm’s records should not be open to challenge. Otherwise, given the risk of some clients losing out under the Speed Proposal, as clearly acknowledged in the FCA CP 13/5, any Administrator is likely to be inclined to be very cautious and may be tempted not to go down that path. Unless the Administrator is offered some degree of protection in deciding to go down the Speed

² It must be assumed that there would be carve outs from any immunity for fraud, and behaviours such as wilful misconduct or bad faith.

³ See, for example, paragraph 74 of schedule B1 of the Insolvency Act 1986. The system of insolvency practitioner personal liability is an inherent element of the insolvency regime, although of course it is not an absolute standard - any person who loses out as a result of Administrator or liquidator conduct does not have an automatic claim against the insolvency practitioner.

⁴ However, in USA IP liability is limited to claims of wilful misconduct, fraud and gross negligence. See Chapter 7.

Proposal route, the “alternative” outlined in paragraph 2.19 of the FCA CP 13/5 (which I describe as the fall back in Chapter 6) could end up becoming the default option.

Client Preference

5.14 By “Client Preference”, I mean the concept that a failed firm’s clients, in addition to their rights under the statutory CASS trust, should enjoy, in relation to any shortfall, a claim in the Firm’s Estate which ranks ahead of (presumably, unsecured and non preferential) creditors of the failed firm.

5.15 The first point to make about this is that the main legislative and regulatory objective should be to have a Client Assets regime which, as far as possible, is designed to ensure that there are no shortfalls of Client Assets, so that clients and non-clients do not need to be in competition for the failed Firm’s Estate. So client preference is in that sense the wrong policy tool, or, at least, a second order method of protecting clients. One assumes that if non-client creditors are to be at risk of becoming subordinated, they will factor the increased risk into the cost of doing business with investment firms and that, ultimately, this incremental cost will be passed on to clients by investment firms.

5.16 I do not have any evidence as to the likely differential outcomes for clients (and non-clients) in SAR cases to date of applying a client preference principle and as such cannot find any basis to make a recommendation for client preference.

5.17 There is, however, one situation where I consider that a case can be made for a limited degree of client preference. Some firms are permitted to use the ‘Alternative Approach’ which involves the payment of Client Monies into a general firm account, subject to a suitable accounting and transfer at the end of each business day. This must increase the risk that, at the point in time at which a firm fails, the house funds include the proceeds of Client Money, which is an unfair result from the client perspective.

5.18 I recommend therefore that there should be a mechanism which allows the Administrator to transfer out of credit balances on a firm account sums which they consider (based on a purely mathematical exercise, rather than applying Tracing principles) to reflect the proceeds of payments made by clients, or by third parties for the account of the firm’s clients, into a firm account and not transferred into a client account prior to the failure.

5.19 This would leave the more delicate question of whether negative or overdrawn balances on firm accounts could be adjusted, after the failure, to rectify what may prove to have been the use of Client Monies to reduce a firm’s own bank borrowings. Logically, this should be the case, as Client Monies should not be used to pay the investment firm’s debts. One way of dealing with this would be to prevent the use, for the purposes of the Alternative Approach, of firm accounts which had the capacity to go into overdraft and to qualify banks’ pooling (or equivalent) rights so that they do not extend to such accounts. I recommend that the FCA considers the feasibility of this.

5.20 This recommendation is limited to cases where the Alternative Approach is adopted. Should this recommendation be taken forward, it may be appropriate to consider: whether the Administrator should be entitled to exercise this power unilaterally or should obtain Court consent; and the desirability and practicability of extending the principle more widely, as is the case under the US regime. (See also Chapter 7).

Costs

5.21 The order of Priority of paying the Administrators' costs of dealing with Client Assets is addressed both in the CASS Rules⁵ and in the SAR⁶. In both cases, these costs (including of potentially sizeable litigation) are paid first out of the Client Asset pool. In respect of Client Money, this Priority is currently a term of the statutory trust. Presumably, it must therefore reflect an underlying regulatory policy.

5.22 To the extent that this generates a shortfall in Client Assets, there may be a claim by the client as an unsecured creditor (*pari passu* with unsecured and non preferential creditors) in the failed firm's general estate.

5.23 The Priority given to costs may reflect the practical need, in an insolvency, to fund the work required to facilitate return of assets. It also reflects the principle established in earlier cases such as *Berkeley Applegate*⁷ dealing with the costs of return of shared interests in a trust fund held by an insolvent.

5.24 I attempted to obtain some statistics on the likely differences in outcome for creditors if these costs were borne by the non-client estate, but only have limited data to hand. In a recent case in the MF Global SAR, it was noted that approximately 65 per cent of client monies and 90 per cent of client assets have been returned or transferred to date and an estimated shortfall for clients of 15 to 20 per cent.

5.25 How costs fall, as between the firm and client estates, may appear somewhat arbitrary. For example, the most recent MF Global case, which dealt with clients' rights, was technically a question of the claims of the clients in the failed Firm's Estate and the costs were therefore borne by the Firm Estate.

5.26 In practice, it may prove difficult to maintain a clear distinction between costs attributable to dealing with Client Assets (and the client's associated contractual claims) and costs attributable to the failed Firm's Estate. The SAR currently provides only limited guidelines on apportionment. I recommend that the SAR Regulations on costs should be expanded to clarify points currently not addressed.

5.27 The rationale, in insolvency, for costs of dealing with Client Assets to be borne by the fund of which they are part is that this is a fund which is separate from, and does not belong to the failed firm. It is therefore not fair to the firm's general creditors for the costs to be borne by the general estate.

5.28 Since a preference for costs is built into the current CASS regime and is reflective of the general legal position, I have not found a sufficiently strong reason to justify a general recommendation that the SAR should provide that the Administrator's costs of dealing with Client Assets should be met out of the Firm Estate rather than out of Client Assets, when this would create a discrepancy between the SAR and the (current) Client Money Rules. (Clearly, if costs were borne out of the general estate, as occurs in the US, this would favour clients, but I cannot find an objective reason why they should be.)

5.29 On the other hand, some at least of the Client Asset costs in any particular case may be directly attributable to failures by the firm (either in terms of non segregation or of record keeping). I therefore recommend that the Courts be given power, through the SAR, to direct that

⁵ In respect of client money, the statutory trust created in CASS 7.7 envisions that funds in the CMP may be used to pay costs properly attributable to the distribution of client money.

⁶ See Rule 135, The Investment Bank Special Administration (England and Wales) Rules 2011, SI 2011 No 1301.

⁷ *Berkeley Applegate (Investment Consultants) Limited (No 3)*, (1989) 5 BCC 803.

some Client Asset related costs in the administration can be paid out of the Firm Estate if the failed firm's conduct prior to failure has exacerbated the problems associated with the Administrator's dealing with the Client Assets. In making this recommendation, I am anxious that it does not provide scope for further litigation in SAR cases. For this reason, I recommend that guidelines be drawn up by the Insolvency Service in conjunction with the FCA and practitioners as to the factors which would justify the exercise by the Court of any such discretion.

5.30 The FCA CP 13/5 contains a discussion of policy in relation to the use of "buffers" (overfunding Client Money pools with the firm's own funds to address specific risks). Paragraph 4.85 of FCA CP 13/5 in particular contemplates that a buffer might be used to cover anticipated costs of distributing Client Assets in insolvency. This seems sensible and I support it, provided the costs to the industry as a whole are proportionate. If this proposal in the FCA CP 13/5 is implemented, it is an additional reason for not burdening the Firm Estate with Client Asset costs. If the use of a buffer for these purposes is voluntary, clients of an investment firm may wish to be informed in client communications whether the firm operates such a buffer, because this would be relevant to the risk of shortfall if the firm fails.

Reliance on records

5.31 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.

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

5.33 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.

5.34 This is a topic which is raised by the FCA CP 13/5 and I do not propose to add to the comments I have included in Chapter 6.

5.35 The discrete recommendations that follow from the issues raised in this chapter are set out in Chapter 8 at paragraphs 8.28, 8.29, 8.45, 8.46 and 8.51.

6

Observations on FCA consultation paper on CASS rules

6.1 The Terms of Reference rightly stressed the need for my review to work in parallel with the FCA’s own work on reassessing the CASS Rule book, in the light of experience to date.

6.2 The FCA published the results of its latest thinking in the FCA CP 13/5, issued in July 2013. I have considered the FCA CP 13/5 as part of my review and in this chapter set out some views, comments and recommendations. The FCA CP 13/5 covers a wide range of issues in relation to the CASS Rules, not all of which intersect directly with the SAR Review. It is outside the scope of this second report to comment exhaustively on the FCA CP 13/5.

6.3 It is evident that the FCA recognises the need to reform the current CASS rules and to learn from the experience both of LBIE and of the SAR administrations to date, as well as the legal decisions to which they have given rise.

6.4 Key aspects of the FCA CP 13/5 that have a bearing on the SAR or on client protection in insolvency of an investment firm are:

- 1 Some alternative proposals (discussed below) to reform and, in particular, designed to speed up the return of Client Monies when an investment firm fails;
- 2 Revisions to the regime applicable to the use of the FCA’s ‘Alternative Approach’ for receiving and applying Client Monies;
- 3 Clarification of the FCA’s approach to the use of buffers;
- 4 Enhanced communication requirements, notably in relation to cases where a client gives up, or reverts to its right to Client Asset protection (“Switching”);
- 5 Proposals for limited use of multiple pools of Client Monies;
- 6 Proposals for the limited introduction of the insolvency “Hindsight”¹ principle into the CASS distribution rules;
- 7 Reforms designed to allow for the transfer of Client Monies as part of a portfolio transfer of client business of a failed firm to another firm.

6.5 I note in passing that the proposals, although in some respects radical, continue to be founded on the concept of Client Monies being protected by being held on the terms (set out in CASS) of a statutory trust. This may be because this is what the primary legislation, FSMA, on which the FCA relies for its authority, contemplates.

6.6 By far the most radical of the proposals relate to the return of Client Monies following a Primary Pooling Event. The FCA had in earlier documents identified a tension in the existing arrangements between speed of return of assets and accuracy of return. This was discussed in the Interim Report.

¹ Under this principle, a creditor’s claim, which may only be capable of estimation at the outset of an insolvency, can be re-valued to take account of its actual amount if that is determined during the course of the procedure.

6.7 At one extreme, therefore, the FCA tables for discussion a “Speed Proposal” which involves:

- 1 the Administrator rapidly reviewing the failed firm’s records;
- 2 the Administrator forming a view as to whether they can reasonably determine client entitlements from those records; and
- 3 assuming they do so conclude, the Administrator makes an internal reconciliation, based exclusively on the firm’s records, and then makes a rapid first distribution of cash to clients based on those records;
- 4 a subsequent distribution may be made from any residual pool of Client Money following a claims process, taking account of client entitlements not apparent from the failed firm’s records; and
- 5 assuming the Administrator is unable to conclude that they can reasonably determine client entitlements from the failed firm’s records, and in certain other circumstances, then as a fall back the Administrator would follow an alternative process² somewhat similar to the current CASS Rules, involving a single combined Client Money pool and a process under which clients would submit claims. In this chapter, I refer to this as the “fall back”, to avoid confusion with the “Alternative Approach” under CASS.

6.8 The FCA acknowledges that the Speed Proposal may create losers if a failed firm’s records are inaccurate or not up to date, so that there are clients whose Client Money claims are not recorded or are inaccurate and who therefore miss out from the interim distribution. There could also be winners, in the sense of clients who are in fact owed less than the records of the failed firm indicate.

6.9 If responses to the FCA CP 13/5 do not indicate sufficient support for the Speed Proposal, the FCA propose to codify the existing regime, presumably as clarified by the Court decisions in LBIE and MF Global.

Comments on some of the proposals in the FCA CP 13/5

6.10 I set out below some comments, from the perspective of the SAR review and the objectives of the SAR, on some of the proposals in the FCA CP 13/5.

FCA powers

6.11 The FCA CP 13/5 stresses in a number of places that there are limits on the FCA’s powers and that the proposals in the FCA CP 13/5 represent the limit of those powers. The precise constraints are not spelled out. I assume that they are a combination of UK primary legislation (FSMA) and mandatory supranational legislation such as MiFID (Markets in Financial Instruments Directive) and EMIR. The FCA makes express references to constraints under general insolvency law. It would be unfortunate if shortcomings in UK primary legislation precluded the establishment by the FCA of a robust and effective Client Assets regime.

Speed Proposal

6.12 My views on the Speed Proposal are as follows:

² See paragraph 2.19 of the FCA Consultation Document.

- The Speed Proposal is premised on the conflict between speed and accuracy. I would hope that, going forward, a firm's records will be a more accurate indicator of the up to date position, so that the perceived dichotomy between speed and accuracy may become less acute than has been the case to date. A number of factors ought to contribute to this:
 - A significant problem arose in the LBIE administration because of the failure to treat affiliates as clients, which I understand created a major discrepancy between what should have been segregated as Client Assets and what was in fact segregated. In the future, an error of this nature ought not to be repeated;
 - MF Global (UK) Limited records were affected and complicated by clients who had previously surrendered Client Asset protection (through use of title transfer collateral arrangements (TTCA) seeking at the last moment to contract back into it. The FCA in CP 13/5 has made separate proposals in relation to this area to introduce restrictions on the means by which clients are able to switch out of (TTCA).³
 - More generally, it is paramount that a firm's records should in the future be the subject of much closer monitoring in going concern mode.
- It is not immediately evident that the Administrator will be in possession of all the information they need, from the firm's records, to carry out the reconciliation required before they make the first distribution. Data may be held by third parties, or counterparties may need to carry out computations of close out amounts.
- The existence of the fall back (the reasons for which I fully understand) means that, in practice, the Administrator's task is to make a decision between the Speed Proposal and the fall back. There must be a risk that the Administrator, unless their decision is absolutely protected from challenge, may go to Court to seek directions, delaying the distribution process. There must also be a risk that the fall back becomes the default process.
- More generally, the Speed Proposal will only work in practice if the Administrator's decision and reconciliation work cannot be challenged. It may prove difficult to prevent those who fear they will lose out as a result of implementing the Speed Proposal from threatening or launching litigation, or leading an Administrator to seek directions⁴. Consideration may need to be given to whether banks holding the failed firm's Client Money might also need a degree of immunity, in case imaginative litigators seek to target them so as to frustrate use of the Speed Proposal.
- There may be a need for some clarity on how the Speed Proposal would work with the FSCS compensation regime for eligible clients and the impact on the FSCS' subrogation rights. For instance, would the FSCS pay differential amounts of compensation depending on whether a particular client had lost out from the Speed Proposal?

The Codification Option

6.13 Codification is presented as an alternative to the Speed Proposal. It seems to me that this will be required in any event, given that the fall back to the Speed Proposal is essentially a

³ FCA CP 13/5, paragraphs. 4.20-4.24

⁴ I have discussed Administrator immunity further in Chapter 5 above.

variant of the current CASS distribution procedure, which needs to be codified. Any codification should take account of the practical concerns expressed about the outcome of recent Court decisions, (for example, in relation to Tracing), and should therefore introduce workable substitutes for any impractical general legal or equitable principles on which the Courts would otherwise have to fall back.

Transfers

6.14 The FCA proposal in this area is consistent with one of my key themes, namely facilitation of transfers of client positions of failed firms and I therefore welcome it.

My recommendations linked to the FCA CP 13/5

6.15 Revisions to CASS and SAR should be designed to work in harmony. Accordingly, I set out below a series of specific recommendations associated with the proposals in the FCA CP 13/5, if these are implemented.

6.16 I hope that the FCA will be able to consider them in conjunction with its review of responses to the FCA CP 13/5 and that there will be an opportunity for affected stakeholders to communicate their views on my recommendations, and on the report more generally, before the FCA finalises its CASS proposals.

6.17 As the FCA CP 13/5 recognises, there will need to be a joint exercise between FCA and Treasury to agree on appropriate and coordinated changes to SAR and CASS.

Speed Proposal

6.18 If the FCA decides to proceed with this proposal, the precise formulation of the rules will be particularly important, so as to ensure the clarity and certainty without which speed is unlikely to be achieved. I therefore recommend that, quite apart from the usual exercise of consulting on detailed rules, an especially painstaking exercise should be carried out on the precise drafting of the applicable rules, involving experienced Administrators, in house Client Asset specialists at investment firms and expert financial services and insolvency lawyers. This is designed to reduce the risk of there being ambiguities or lacunae in the final CASS Rules, or inconsistency with other rules, which would render references to Court inevitable in future complex investment firm failures.

6.19 The Speed Proposal will in my view necessitate immunity for any Administrator going down the speed route. In particular, the SAR would need to be amended to qualify or remove the rights of persons adversely affected to invoke paragraph 74 of schedule B1 to the Insolvency Act 1986.⁵

6.20 In order to avoid the policy behind the Speed Proposal being frustrated, the availability of the fall back will need to be circumscribed. The principal proposed FCA criterion for operating the Speed Proposal is that the Administrator forms a view that client entitlements can reasonably be determined from the failed firm's records. This of course immediately raises the question of who determines what is reasonable. Arguments over this could paralyse the Speed Proposal. One possibility which should be considered is whether the Administrator who considers that the firm's records can be relied upon to determine client entitlements should (without unduly delaying the process) provide a reasoned analysis to the FCA and, if the FCA is satisfied with the analysis, the Administrator's decision to proceed with the Speed Proposal

⁵ This gives creditors in certain circumstances rights to challenge the conduct of an administration if they consider they are unduly prejudiced. It applies to a SAR.

could not be challenged. An alternative might be to introduce a “fast track” process for Court consideration of the Administrator’s proposals as between the Speed Proposal and the fall back.

Codification

6.21 As mentioned elsewhere in this document, this is likely to be needed in any event. Rules should be built into CASS Rules which stand in place of unworkable general law principles, for example, Tracing.

Alternative approach

6.22 I recommend that there should be a power for the Administrator to top up Client Money shortfalls from firm funds where Client Monies were not paid into client accounts prior to the firm’s failure (see Chapter 5 and 8).

Buffer

6.23 The FCA takes the opportunity to clarify its policy in relation to the use of buffers, so as to address specific risks. I support this proposal, particularly in relation to the potential costs of distribution of Client Assets if a firm fails. Clearly the use of buffers needs to be cost effective.

6.24 The discrete recommendations that follow from the issues raised in this chapter are set out in Chapter 8 above paragraph 8.93.

7

An international comparison

7.1 Two of the largest investment firm group failures in recent years (Lehman and MF Global) involved procedures in both the USA and UK (as well as elsewhere for Lehman). It makes sense therefore to see if any lessons can be learnt from the way similar issues are handled in other jurisdictions.¹

7.2 I was particularly drawn to look at how the US processes in Lehman and MF Global have worked because of the existence of widely held views in some parts of the London marketplace that the US system is markedly superior, compared to the UK regime, both pre and post SAR, in terms of delivering rapid and satisfactory outcomes for clients of failed investment firms.

7.3 I have had the benefit of a conversation with representatives of SIPC, with the Trustee in the US Lehman and MF Global cases and their advisers; I am grateful to them for their time. Any failure to take adequate account of their guidance is my responsibility alone. The summary below is not intended to cover every possible comparison or to provide a full picture of the US regime.²

7.4 What follows in this chapter is a very high level overview of what I see as the principal commonalities and differences between the systems and some conclusions about what the UK could do to improve its regime. In a number of respects, the comparative conclusions I draw below reinforce my general recommendations in Chapter 8.

7.5 I should start by commenting that the two regimes seem to me less different in overall outcome than I was expecting to find. They do vary enormously in technical detail, but that is inevitable since the investor protection and insolvency regimes and practices, including legal cultures, of which the special regimes form part, are themselves divergent.

7.6 For simplicity, in this chapter I use the phrase 'Client Assets' indiscriminately, to describe the nature of the segregated entitlements (including in respect of Client Monies) of a client of a US or UK firm, although I appreciate that the exact nature of the client entitlements are different in the two regimes and that this may itself produce substantively divergent results.³

7.7 Much of the US regime has been in place for longer than in the UK. The longer period of time in force may have allowed a greater degree of familiarity to develop as to its operation and effect. So far in the UK, it is only the MF Global administration which has shed substantive light on some of the details of the SAR and its interaction with CASS.

7.8 Both systems start from the principle that one of the key differences of a failed investment firm, compared to other insolvent businesses, is that it will be in control of a significant asset portfolio belonging to its clients and that it is a high policy Priority to protect and deal as expeditiously as possible with that portfolio.

¹ Time and resource constraints have only permitted an examination of the US system, and that review has itself been superficial. It may be that there are other models which it would be useful to explore.

² I note that some of the aspects of the US regime do not apply to all types of US investment firms in exactly the same way. For example, differing parts of the bankruptcy legislation may apply depending on whether a firm is engaged in securities brokerage or commodities trading.

³ The US relies on an autonomous right set out in statute, whereas English law entitlements are based on a statutory trust and general principles of trust law.

Transfer

7.9 In the US, the main way this may be achieved is by prioritising and facilitating, where possible, a very rapid transfer of client positions to a third party firm. Two particular aspects of the regime facilitate this. First of all, the fact that a Court approved bulk transfer can be achieved without the need for individual client consent. Secondly, the existence of a substantial industry funded compensation fund allows the transferee firm of a securities brokerage business to be offered protection from shortfalls in Client Assets within the transferred portfolio. Experience shows that the use of this process both in Lehman US and MF Global US was beneficial to those of the firms' respective clients who were included in these initial transfers.

7.10 There is, however, no certainty that a transfer can be achieved or that it will extend to all client positions. Where, for whatever reason, client positions cannot be transferred, there is likely to be a similar process in the US as in the UK of calculating and reconciling net client positions for the purposes of establishing the client's net claim over Client Assets in the bankruptcy proceedings. I understand that in some US cases, this process has understandably taken a considerable period of time to resolve.

Costs

7.11 A significant difference between the US and the UK regime is that, whereas the UK regimes (both CASS and SAR) provide for costs of dealing with Client Assets to be borne out of the client estate, under the US regime, costs will usually be borne by the general estate. There may even be access to funding from the compensation fund in cases where the general estate may not be able to support all the costs. This is likely to reduce any shortfalls for clients. Whether it also improves speed of return of assets of those not benefitting from early transfers is less clear.

Client Preference

7.12 It has been suggested that there is a general client preference principle built in to the US system. I do not consider that this is in practice the case. There are provisions allowing the Trustee, with Court consent, to appropriate from the Firm Estate assets corresponding to what should have been, but was not, segregated by the failed firm. However, this is not simply a unilateral right on the part of the Trustee but needs to be justified before the Court, where opposing interests can make submissions to the contrary. (I understand that, in practice, negotiations take place outside the Courtroom, so that, wherever possible, what is presented to the Court will be an agreed compromise)⁴.

Office Holders duties and position

7.13 In my Interim Report, I highlighted the tension inherent in the structure of the SAR between the objectives of prioritising Client Assets without conferring any preference to clients' claims, compared to those of non client creditors. It has been interesting to note that in a US firm failure, the Trustee is considered to have duties not just to clients but also to general creditors. So both regimes display an element of this tension.

7.14 In view of the discussions which have taken place about the perceived delays which may be caused by the lack of an Administrator immunity, it is also worth noting that the trustee in a US

⁴ In November 2013, it was announced that the US Commodities Futures Trading Commission (CFTC) had obtained a federal court consent order against MF Global Inc., under the terms of which MF Global Inc. is required to pay to its clients agreed amounts as restitution and by way of remedy for breach of CFTC rules. It is understood that, as a result of this order, MF Global Inc.'s insolvency practitioner will allocate to clients from the firm's general estate a sum sufficient to make good shortfalls in client assets of MF Global Inc. Since these payments will be made out of MF Global Inc.'s own assets, it could be seen as giving clients (at least in economic terms) a form of priority over other creditors of MF Global Inc.

case does not benefit from any express immunity.⁵ The fact that many decisions are submitted to the Court for approval may provide some practical protection.

Role of the Courts

7.15 It is the US bankruptcy Courts which have jurisdiction over investment firm insolvencies in the US. In all insolvencies, (not just in the financial services sector), there is a marked difference between the roles and approaches of the US and UK Courts. English law confers wide powers and discretions on the Administrator, who is accustomed to making commercial decisions without seeking their ratification by the Court. The English Courts are much less “hands on”, and do not expect to be asked to take or approve purely commercial decisions. US bankruptcies involve the Courts to a much greater extent. It is also clear that, before any major bankruptcy hearing in a particular case there will be a considerable amount of debate and negotiation among the interested parties as well as detailed submissions to the Court. All that process must take time.

7.16 I have concluded that the differences between the respective roles of the UK and US Courts reflect the different underlying systems and cultures and that there are no additional “structural” recommendations to draw in this area from the US system.

Affiliates

7.17 By virtue of MiFID, an affiliate (such as a sister company) of a failed firm in the UK (or elsewhere in the EU) should be treated like any other client. The US position is more nuanced. They can have ordinary client status, but this is not mandatory. For unrelated regulatory reasons, I understand that affiliates of US firms may tend to waive Client Asset protection status.

Bar Dates

7.18 The US regime allows for more definitive Bar Dates, which may accelerate the closure of a failed firm in the USA.

Conclusions

7.19 The conclusions set out below are tentative, because a more extensive research and comparison would be called for before making a final decision to implement them. However, as will be seen, they are consistent with the other conclusions and recommendations in the report:

- 1 The UK regime should be enhanced to facilitate transfers of client positions without the need for individual client consent at an early stage in the administration. (See Chapter 8). The fact that FSCS can now participate in facilitating a portfolio transfer is an encouraging development, although the relatively modest FSCS limits (compared at least to amounts available in the USA) will limit the assistance that the FSCS can provide.
- 2 There should be a mechanism for the Administrator to transfer from the Firm Estate funds or assets which should have been segregated but were not (for example, under the requirements in CASS). This remedy should be available whether or not Tracing is available. As already mentioned in paragraph 5.20, I am only making a specific recommendation where a firm uses the Alternative Approach, but a wider adoption of the principle should be considered if the recommendation is taken forward.

⁵ Although there is no immunity, I understand that officeholder liability is limited to only claims of wilful misconduct, fraud and gross negligence so is significantly reduced.

- 3 There should be flexibility for the Court to order that some or all of the costs of dealing with Client Assets should be borne by the Firm Estate. In the interests of keeping down the costs of such applications, guidelines should be developed as to the circumstances which should justify the use of general estate monies. (See Chapter 5).
- 4 Stakeholder views should be canvassed as to the appetite for a more generous industry funded compensation scheme to supplement the current FSCS arrangements, with the likely knock on impact in terms of costs of doing business in the London Market. In this connection, I note a recent development in the form of private sector insurance in respect of the losses a client may experience over and above FSCS compensation, where available. This may be another avenue for market practitioners, the FCA and the FSCS to explore.
- 5 Once the Lehman and MF Global cases are substantially complete on both sides of the Atlantic, there should be a comparative exercise to look at the outcomes (in terms both of amounts returned and time taken) for clients and non client creditors in each estate, with a view to determining if there are any other factors, not identified above, which have contributed to the differences in result and whether any consequential changes to CASS or the SAR could be made to facilitate better, fairer, more rapid or less costly outcomes.

7.20 The discrete recommendations that follow from the issues raised in this chapter are set out in Chapter 8 in paragraphs 8.3, 8.45 and 8.92.

8

Recommended improvements to the SAR

8.1 I set out in this chapter my final recommendations. These include those I initially made in my Interim Report (some of which I have refined), and a number of additional points I have now considered.

8.2 My Recommendations are grouped into the following categories:

- A. Facilitating transfers
- B. Bar Date reforms
- C. Making CASS and SAR work together better
- D. FSCS recommendations
- E. Information sharing and cooperation duties
- F. Other SAR recommendations
- G. Role of the Courts and dispute resolution
- H. Some more general recommendations
- I. Behavioural recommendations

A. Facilitating transfers

Transfer mechanism

- 1 Introduce a SAR mechanism to facilitate rapid transfer of customer relationships and positions, where feasible. (SAR Objective 1)¹

Return/Transfer objective

- 2 Amend relevant SAR objective from “return” of Client Assets to a more explicit reference to “return or transfer”.²

8.3 I recommend a greater focus be given to facilitating transfers within the SAR. This is partly a question of emphasis, in that there is nothing in the SAR to prevent a transfer of Client Assets to a solvent investment firm rather than the return of the assets to its clients. So the concept of transfer is already implicit in the SAR. Indeed, the Act³ makes clear that references to a return of Client Assets include references to transferring them to another institution. All that may be missing are some mechanical and practical provisions to implement transfers (see below).

¹ This refers to recommendation 1 on page 28 of my Interim Report.

² This refers to recommendation 2 set out on page 28 my Interim Report.

³ See s.233 (4) of the Act

8.4 I note that in the case of the smaller SAR firms to date, it has been possible to achieve some measure of transfer of client positions in an ad hoc manner. I see value in encouraging this option by introducing into the SAR a mechanism to facilitate such transfers. Other special insolvency regimes (for example in the Energy Act 2004) may provide useful examples.

8.5 Further reasons for this recommendation include:

- The limited review I have been able to carry out of the US regimes dealing with failures of comparable firms (as discussed in Chapter 7), has demonstrated the primacy in the US regimes of arranging, wherever possible, a rapid and orderly transfer of client positions to a solvent counterparty. Where that has occurred in US cases, it is likely to have improved outcomes for transferring clients, compared with the impact of the firm's failure on clients whose positions it has not been possible to transfer for whatever reason. I consider that this should also be the case in the UK;
- Some private clients, (with pension or ISA investments), may be prejudiced by a return of Client Assets rather than a transfer.
- Certain long term or structured investments may be devalued by a premature closeout. A transfer of the investment may enable early closeout to be avoided.

Implementation

8.6 Particular points which would need to be addressed in any transfer regime include the following: (This is not a comprehensive list – a legal procedure needs to be put in place to allow such transfers to be formalised or approved.)

- The power to novate client contracts without individual client consent and to override any restrictions which might otherwise give a client the right to object to a transfer. The quid pro quo for this forced transfer power may be giving transferring clients the right to move their accounts from the transferee during a period after they have been notified of the transaction.
- Provisions to override any confidentiality or data protection rules which might otherwise preclude the transfer of data to the transferee.
- The possible need for a short moratorium on the exercise by solvent third parties of contractual termination or other default rights, under contracts forming part of the client portfolio, occasioned by the firm's failure.
- The impact of the transfer on any liabilities owed by the transferring client to the failed firm and the potential loss of set off rights.
- My understanding is that, typically in ad-hoc transfers to date, the FCA has had to grant a number of temporary waivers in order to ensure the transferee firm is not in breach of regulatory obligations to its newly acquired customers. Consideration should be given to formalising this process, or at least recording the terms on which such waivers can be expected to be given.

Use of Nominee Companies

- 3 FCA should consider encouraging firms, in appropriate cases, to use a wholly owned subsidiary as the nominee company to hold legal title to client investments (other than cash).

8.7 Some investment firms, notably those with a preponderantly private client customer base, have traditionally used a separate nominee company subsidiary to hold all Custody Assets.

8.8 In at least one SAR case to date, the rapid transfer of client positions to a solvent successor firm was facilitated by the fact that the failed firm held substantially all its (UK) Custody Assets in the name of a separate nominee company subsidiary. It was possible to transfer the shares in that nominee company as part of the transfer of client positions. The transfer of the shares in the nominee company was sufficient to produce the result that all the client holdings registered in that nominee passed into the control of the transferee, without the need for transfers of individual holdings. I recommend that consideration be given by the FCA to encouraging this practice. (I have explained above why a transfer will often be considered favourable to a distribution.)

B. Bar Date reforms

Extend Bar Date to Client Monies

- 4 Bar Date mechanism should be extended to include Client Monies⁴.

Align treatment of Client Money and Custody Asset claims

- 5 SAR treatment of claims associated with client monies to be aligned more closely with treatment of claims relating to Custody Assets.

Permitted Distributions

- 6 The Administrator should be permitted to make distributions of certain Custody Assets during period after the Bar Date process commenced⁵.

Final Hard Bar Date

- 7 Where the Administrator has set one or more 'soft' Bar Dates, SAR should allow for a final 'hard' Bar Date to be set that is definitive and exhausts client claims.

8.9 Having made enquiries as to the reasoning behind the introduction in the SAR of a Bar Date for custody assets but not Client Monies, I am satisfied that there was no overriding policy reason for excluding Client Monies from the Bar Date procedure. It seems that, as the Courts were already considering the precise application of the Client Money rules in the LBIE insolvency, it was decided not to include any substantive provisions in the SAR pending the outcome of those cases.

8.10 I conclude therefore that the exclusion of client monies from the Bar Date procedure is anomalous and should not be maintained.

8.11 I am fortified in this view by developments in the MF Global case, where the Administrators have successfully requested the Court to permit them to establish an ad hoc Bar Date mechanism so as to facilitate the return of Client Money to clients.

8.12 During the course of the second phase of my review, it has become clear that the way client claims attributable to Client Monies (as distinct from Custody Assets) are (or are not) currently legislated for in the SAR is liable to throw up a number of complex questions in SAR administrations. As mentioned in Chapter 4, I recommend that a comprehensive review be carried out of the treatment of client claims on the failed Firm's Estate resulting from Client

⁴ This refers to recommendation 4 set out on page 29 of my Interim Report.

⁵ This refers to recommendation 5 set out on page 30 of my Interim Report.

Money entitlements, with a view to deciding whether the treatment of SAR Client Money claims can be more closely aligned with the SAR treatment of claims relating to other Custody Assets.

Flexibility for Administrator Distributions

8.13 I have not been able to establish the rationale for the inclusion in the SAR of the provision which precludes distributions to individual clients once the Bar Date procedure has been launched. Based on my discussions with Administrators, it seems to me that this is unnecessarily prescriptive and inflexible. If the Bar Date mechanism is extended to Client Money, this inflexibility will potentially become more extensive.

8.14 Clearly an Administrator would only use the power to make individual distributions after careful consideration of the particular circumstances.

8.15 Given that the overriding objective of the SAR is to facilitate the speedy return of Client Assets, I consider that an Administrator who is confident as to an individual client's position should be able to distribute all or part of that client's assets even if they have commenced the Bar Date procedure for distribution of Client Assets more generally.

Hard/ Soft Bar Date

8.16 A Bar Date mechanism is designed to facilitate the making of distributions by the Administrator. The Administrator may set a date by which clients must submit their claims, failing which they will not participate in the upcoming distribution.

8.17 This does not necessarily mean that a person who fails to submit a valid claim in time completely loses out – they may have a right to catch up, at least partially, by participating in a subsequent distribution.

8.18 This is what the SAR currently contemplates. I consider that this is the right approach. This is sometimes called a "soft" Bar Date. A "hard" Bar Date, on the other hand, is one where the person who fails to submit in time simply loses their entitlement.

8.19 In most cases, distributions (particularly of Client Monies) will take place in stages. This being the case, I recommend that there should be a procedure in the SAR for the Administrator who has been through one or more "soft" Bar Dates to set a final "hard" Bar Date which will be definitive and exhaust client claims.

8.20 Given that this would entail extinguishing proprietary rights of those who have not claimed, I consider that the Administrator should need to obtain Court consent to set a "hard" Bar Date and that they should be required to demonstrate to the Court, in particular, what action they have taken to trace clients shown in the failed firm's books who have not submitted claims.

8.21 The FCA CP 13/5 contains some general proposals relating to assets held by a firm in respect of "lost" clients. If my recommendation is adopted, it may therefore be necessary to align this recommendation with the policy adopted by the FCA more generally in this area. This might be achieved, for example, by the Administrator paying amounts with respect to what they consider to be valid accounts of non claiming clients to a third party trustee or into Court.

C. Making CASS and SAR work together better

Relationship between the SAR and CASS

8.22 The following section groups together many of my proposals having a bearing on CASS.⁶ Recommendations 8 to 14 are what I consider to be important reforms to address the relationship between the SAR and CASS. They are discussed in detail in Chapter 3 or 4, where there is a fuller discussion of the issues and anomalies which currently exist.

Client Assets: Consistency

- 8 SAR and CASS need to be consistent: clarity on clients' rights to income, interest and/or distributions in respect of Client Assets and interest on Client Monies, in respect of period of administration, and which rules to apply.

Clarify SAR Objective 1

- 9 Amend drafting of SAR objectives to provide that Administrator's role in pursuing Objective 1 is to apply the applicable distribution regime laid down by CASS. This is to make clear that the client's entitlement as a client is to be sought in CASS.

Clarify Rights to Income during Administration Period

Relationship between CASS and SAR rights

- 10 Ensure relationship between client's rights under CASS in respect of Client Assets and its rights to make claims as a creditor are clearly set out and understood and do not operate unfairly to other creditors.

Clarify basis for Client Money shortfall claims

- 11 SAR should set out the basis on which clients making partial recoveries of Client Monies under CMP Entitlement are entitled to make claims against the failed firm's estate.

Costs Apportionment

- 12 SAR guidance needed on how costs borne by the failed firm's general estate and client money estate should be apportioned.

Harmonisation of treatment of Client Monies and Custody Asset claims

- 13 Harmonise SAR treatment of Client Money and Custody Assets unless there is a good reason not to.

Extension of Hindsight Principle

- 14 FCA to consider whether Hindsight Principle could be introduced for CASS Client Money Pool Entitlement purposes.

8.23 In my Interim Report, I recommended that the SAR regime should clarify rights of clients to:⁷

- income/interest/distributions in respect of Client Assets; and

⁶ See also section D and H (Recommendations derived from Chapter 6).

⁷ As set out in Recommendation 6, on page 30.

- interest on client monies,

in respect of the period of the administration.

8.24 I now consider that these rights should be clarified, but this could be done either in the SAR or in the CASS rules. CASS Rules may provide a more flexible framework to allow updating as markets evolve.

8.25 In addition, an exercise should be carried out to make sure that the interrelationship between a client's entitlement under CASS to income or interest on Client Assets and their rights as a creditor to interest on their claims are clearly understood and do not operate unfairly to other creditors of the failed firm.

8.26 This is another area where there is scope for friction between the CASS and SAR (or general insolvency) regimes, so clarification is desirable. The fact that some delay in returning assets to clients seems inevitable, at least in cases of any complexity, means that it is important to provide for the question of income arising during the period of the administration.

8.27 It is clear that income accruing during an administration on client non cash assets should belong to the client. This is the natural consequence of the assets being beneficially owned by the client. It may be less clear what entitlements clients have to income or interest earned on Client Monies during the administration.

8.28 The (currently) artificially high rates of interest payable out of surplus on general creditor claims in a solvent administration creates an incentive for clients to arbitrage between client and creditor status, by choosing to present their claims as creditor, not client, claims, generating a higher return during the administration. This is another reason for spelling out what the clients' entitlements are in respect of income on their Client Assets during the period of the administration.

D. FSCS recommendations

Shortfalls

- 15 The FCA should consider extending FSCS compensation for portfolio transfers to cover shortfalls in Custody Assets as well as Client Money shortfalls (provided they fall within the scope of FSCS protection).

Firm records

- 16 Firms in going concern mode should do more to ensure their records would assist Administrators and FSCS to understand the status of their clients for FSCS purposes and how their products are structured and consequently whether FSCS may be able to provide compensation.

Statements on FSCS Entitlements

- 17 Firms should consider explaining in customer statements the circumstances in which FSCS might provide compensation if firm failed and elements of a product that would not be covered.

CASS Resolution Packs

- 18 CASS resolution packs to contain sufficient data to enable the Administrator and FSCS to more speedily identify eligible clients and whether FSCS can provide compensation in relation to any parts of the business of the failed firm.

Creditor committees

- 19 FSCS should be entitled to sit on creditors' committees, regardless of whether it has yet made compensation payments, unless it is clear that no compensation will be payable.

Verifying claims

- 20 Consider alternative methods of providing FSCS with comfort as to rigour of Administrator processes in relation to verifying claims of FSCS eligible clients, such as FSCS working alongside Administrator or agreeing a suitable methodology. This is designed to address delay caused by FSCS verifying Administrator's calculations.

8.29 I have already mentioned that a number of changes have already been made to the regulatory environment since the major SAR cases. This includes the operation of the FSCS in relation to failed investment firms, which was streamlined in a number of ways in autumn 2012, for failures occurring after that date. The FSCS may now participate in transfers of portfolios of failed firms by paying compensation for any shortfalls in Client Monies (but not Custody Assets) to transferees rather than to the firm's clients. This is potentially a major improvement, although the FSCS compensation limit will still apply.

8.30 The FCA (through its predecessor) also dispensed with the requirement that if the FSCS wishes to obtain an assignment from the firm's clients it has to obtain a separate assignment from each client before it pays compensation.

8.31 I continue to recommend the following additional steps, building on these enhancements:

- The FCA should consider whether the compensation arrangements described above in relation to portfolio transfers could be extended to cover shortfalls in Custody Assets (provided they fall within the scope of FSCS protection) as well as Client Money shortfalls.
- More should be done by firms in going concern mode to include flags in their records which will assist Administrators of firms and the FSCS to understand how products are structured and so whether the FSCS may be able to provide compensation. Consideration should be given as to whether customer statements could explain the circumstances in which FSCS might be able to provide compensation if the firm failed and, for example, any elements of a composite product that would not be covered by the FSCS.
- CASS Resolution Packs should contain sufficient data so as to speed up the process of enabling an Administrator and the FSCS to identify eligible clients and the FSCS to determine whether it can provide compensation;
- There should be a duty on the Administrator to collaborate with the FSCS. It has been drawn to my attention that such a duty already exists for both banking and insurance failures.⁸ It should likewise apply to other investment firms and (for clarity) be available whether or not the procedure they go into is the SAR⁹;

⁸ S.99(2) Banking Act 2012, and The Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010 (SI 2010 No. 3023).

⁹ See 'Consideration for the Justification of differences between mechanics of SAR and SRR' in this Chapter for a discussion of the multiple procedures available.

- The FSCS should be entitled as of right to sit on creditors' committees, regardless of whether it has yet made compensation payments, unless it is clear in any particular case that no FSCS compensation will be payable.

8.32 One possible source of delay (and additional cost) in making FSCS compensation payments is the current need for the FSCS to carry out some verification of the Administrator's calculations. This is in part because the FSCS has a responsibility towards those who contribute to the fund to make sure the FSCS only pays out on genuine and verified claims.¹⁰ I recommend that consideration should be given to whether there are alternative methods of providing the FSCS with comfort on these points, such as the FSCS or its representative working alongside the Administrator while the Administrator is carrying out its reconciliation processes, or the Administrator working to a methodology agreed in advance with the FSCS.

8.33 In the Interim Report, I also suggested that consideration should be given to extending the scope of investment business protected by the FSCS. In some cases, identifying which aspects of a failed firm's investment business were protected by the FSCS may have caused some measure of delay in compensating clients. The Interim Report acknowledged that extending the boundaries, which are currently linked to FSMA's definition of Regulated Activities¹¹, could be problematic, as it would break the link between the business activities that are within the scope of the FSCS and the regulated firms which ultimately provide the protection. The FSCS compensation regime is funded by levies on other financial services firms, carrying on broadly similar activities. If compensation were extended beyond the scope of Regulated Activities, this could lead to justified complaints from contributors to the FSCS compensation scheme that they were indirectly subsidising failures in businesses wholly dissimilar from theirs. Also, regulated firms might be subsidising failures of businesses that were wholly unregulated as regards the way the business was carried on. I have accepted the force of this argument.

8.34 Additionally, I have considered the subject of interim distributions where FSCS compensation is available. Administrators understandably wish to be able to make at least partial distributions of Client Assets at the earliest possible opportunity, which the regime allows them to do. Where FSCS compensation is available, a partial distribution can actually complicate and delay the full return or compensation to eligible clients. The FSCS needs to avoid an overpayment or duplicate payment. If any dividend is payable by the Administrator, the timing of FSCS's compensation may need to allow for those dividends to be received and those investors' losses adjusted accordingly, so that the residual balance is correct. Reconciling the balance of overall compensation due can be delayed if a dividend cheque has not been presented. This resultant receipt of two payments for the same loss can be confusing to the investors. I am not recommending any substantive change to the SAR in this area, because this is essentially a practical point. However, it makes sense for the FSCS at an early stage to draw this complication to the attention of the Administrator.

¹⁰ The FSCS also has a duty under the FCA's rules to pay compensation, of the appropriate amount, only where a firm owes a claimant a civil liability (for example the firm has given poor advice and this has caused the loss its client has suffered).

¹¹ Most but not all regulated activities are within the scope of the FSCS.

E. Information sharing and cooperation duties

Co-operation between Administrator, FSCS and transferees¹²

- 21 The Administrator and FSCS should have a duty to co-operate with each other and should have reciprocal co-operation duties with any transferee of all or part of the business of the failed firm.

Co-operation between Administrator and market bodies

- 22 The Administrator and market infrastructure bodies (or any other bodies holding relevant records) should have reciprocal duties for the purposes of reconciling positions of the failed firm.

Co-operation by entities holding Client Assets

- 23 Entities holding Client Assets (including Client Monies) of failed firm should have a duty to investigate and return them promptly.

Co-operation by Banks holding Client Monies

- 24 Banks with Client Money deposits should have duty to assist with reconciliations and return of Client Money.

Co-operation by Counterparties

- 25 Counterparties of failed firm should be required to respond promptly to the Administrator's request for information and financial data such as close out valuations.

Co-operation to facilitate incomplete trades

- 26 Reciprocal cooperation of administrator and relevant parties should extend so as to explore feasibility of completing client trades that are incomplete at moment of failure.¹³

Co-operation involving HMRC

- 27 HMRC should have a duty to cooperate with Administrator to address barriers to speedy resolution of issues relating to tax privileged investments such as ISAs and SIPPs.

8.35 In my Interim Report, I stated that there were 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 between Administrator and market infrastructure body 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; and

¹² Some of these recommendations (21-27) collectively refer to those set out on in Recommendation 3, on page 29 of my Interim Report.

¹³ See also, 'Failed or Incomplete Trades' below

- to the extent necessary, any barriers should be removed, so as to allow exchange of confidential information between the Administrator and market infrastructure bodies.

8.36 I have had the opportunity to be more specific about the ambit of this recommendation.

8.37 More particularly:

- third parties, including central counterparties and custodians, holding Client Assets of failed firms should be required to assist the Administrator both in terms of reconciliation work and also in facilitating a rapid return to the failed firm or direct to its client (or a transfer to a solvent successor firm) of any Client Assets held or controlled by that third party;
- the banks with whom Client Money is deposited, should also be required to assist with reconciliations and return of Client Money. Banks should also, in going concern mode, Prioritise responding to “acknowledgement letters” recording the status and segregation of credit balances of accounts in which Client Money is placed;
- counterparties of the failed firm should be required to respond promptly to the Administrator’s request for information and financial data such as close out valuations;
- the Administrator should be able to work with those organisations involved in processing trades both to obtain up to date information about transactions in course at the moment of appointment and to explore the possibility of completing incomplete transactions carried out for the failed firm’s clients.

8.38 A question which arises is who should bear the additional costs incurred by third parties of complying with any assistance or co-operation required for a failed firm. Whilst I have been unable to procure data on the level of cooperation costs in cases to date, I consider it inevitable that the failed firm should bear exceptional costs, which are then likely to fall on the client estate (unless they relate to proprietary transactions of the failed firm).¹⁴

8.39 The overall objective of the Act and the SAR can only be achieved if there is a degree of co-operation provided to the Administrator by all those who have had dealings with the failed firm prior to its collapse. It is clear from SAR and non-SAR cases to date that an Administrator cannot necessarily or accurately check and reconcile the Client Asset position by reference solely to the failed firm’s books. In addition, a net client position may depend on close out valuations carried out by third parties. Lack of information about some client positions may prevent the Administrator from determining whether there is a shortfall and so may delay return of Client Assets to a larger number of clients.

8.40 It will also be important for the Administrator to keep abreast of any porting of client positions pursuant to EMIR and the impact on the particular client’s net position with the failed firm.

8.41 I would add that I continue to make the recommendation, contained in the Interim Report, that HMRC should have a duty to cooperate with Administrators to address barriers to speedy resolution of issues such as resolving how to speedily transfer ISAs rather than have the monies returned to customers, thereby potentially losing their tax advantages.

8.42 When a firm fails, it will inevitably be in the midst of a number of transactions (buy or sell trades) which it has initiated, in various stages of settlement and clearing, having occurred on numerous different exchanges with their own settlement and clearing rules and practices. Many of these trades will inevitably fail as a result of the firm failure but there may be some which do

¹⁴ Such costs may be reflected in any Client Money buffers established as contemplated by paragraphs 4.82 to 4.86 of the FCA CP13/5.

in fact complete. Any reconciliation required to be carried out by the Administrator at the outset will need to take account of updated information about the status of these transactions.

8.43 I started my reflections on this topic by assuming it might be possible at least to make some recommendation that sell transactions on client accounts (i.e. where the failed firm has taken action to deliver securities and is due to receive payment) should be completed so far as possible. Discussions with the experts in this area indicate that this is an over-simplistic approach. Consequently, I am not making any specific recommendations in relation to failed or incomplete trades. The co-operation arrangements which are built in to the SAR should however extend to doing all that reasonably can be achieved to give effect to pre-failure client instructions.

F. Other SAR recommendations

Administrator immunity

Speedy returns

- 28 Administrators should be protected from any liability if they agree “speedy” returns to individual clients in straightforward, hardship or small value cases. Clients would surrender right to complete accuracy, but remain on the hook for any liabilities to the failed firm.

Staff retention

- 29 Administrators should be insulated from “unfair prejudice” type claims from unsecured creditors if keeping on more staff than absolutely necessary - to ensure no loss of corporate memory/ systems knowhow.

8.44 For the reasons discussed in Chapter 5, I do not support a broad immunity for Administrators. In the Interim Report (paragraph 5.25), I proposed to provide Administrators with a limited degree of immunity in two specific areas:

- 1 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
- 2 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 they have funds available in the estate to meet any such claims.

I continue to support these.

8.45 These recommendations deal with two separate points.

8.46 The first envisages that an Administrator should be given flexibility, at the earliest opportunity, to make “de minimis” (small value) or hardship distributions to clients without necessarily having carried out all the investigations that they might otherwise performed. As a result, it could subsequently turn out that the client was not entitled to any, or the full amount,

of the distribution, or that the Administrator would have been entitled to make deductions from the client's entitlement (in respect of amounts owed to the failed firm). This proposal is not dissimilar to the FCA's Speed Proposal, although more limited in scope.

8.47 As the Administrator might subsequently be criticised or incur liability for making what with hindsight is shown to be an overpayment at the expense of other creditors, I consider that this proposal would only be feasible if the Administrator has a limited form of immunity in affecting such "de minimis" or other exceptional distributions. What "de minimis" would be, may need to be set on a case by case basis.

8.48 The second recommendation in this area is designed to facilitate retention of the failed firm's corporate memory, in the interest of a more rapid and smooth conduct of the reconciliations required before distributions can take place and of the continuity of operation of the firm's systems, to the extent that they have been developed specifically for the particular investment firm.

8.49 The Administrator comes to the failed firm without any prior knowledge of its operations. It has become increasingly clear to me that no two firms are run, or maintain records, in the same fashion. The failed firm's systems are likely to be unfamiliar. Loss of familiarity with the particular practices and systems of the failed firm could delay dealing with Client Assets and carrying out the reconciliations which are a prerequisite to returning Client Assets.

8.50 Additionally, the task of the entities involved in settlement and clearing of the failed firm's transactions in assisting the Administrator may be made more difficult if they have to deal with personnel not familiar with the practices of the failed firm or of the markets in which it operated.

8.51 I therefore consider it important to ensure there are no undue impediments to the Administrator retaining the failed firm's staff, at least until they have built up sufficient familiarity with the failed firm's systems and operations.

CASS Resolution Packs

CASS Resolution Packs

- 30 FCA seek views on proportionate additions to CASS Resolution Packs, to provide maximum assistance to Administrator and FSCS to achieve speedy return or transfer of Client Assets, and prompt payment of FSCS compensation where available.

8.52 I regard CASS Resolution Packs as potentially an important tool in helping an Administrator get up to speed and therefore being able to make more rapid distributions of Client Assets. They should also be of assistance to the FSCS.

8.53 Once a decision has been reached on the revisions to the CASS Rules, I recommend that the FCA should seek the views of market professionals and in particular Insolvency Practitioners, as well as the FSCS, on proportionate additions which could usefully be made to CASS Resolution Packs, so that they provide the maximum assistance possible to an Administrator and the FSCS when appointed to a failed firm and help achieve the goal of speedy return or transfer of Client Assets. One obvious example is relevant internal and external audit reports. Firms that continue to use what is termed the Alternative Approach could include a statement describing how monies are received and subsequently allocated.

Reporting formats

Reporting formats

- 31 Every firm's CASS resolution pack should contain a detailed explanation of how client statements are presented. The particular methodology used by a firm should be clearly set out as part of the client statement.

8.54 Every firm may have its own way of presenting client statements. Large clients will have electronic real time access to data.

8.55 One of the things a newly appointed Administrator will have to familiarise themselves with on appointment is how the failed firm's systems work and what the reports sent to clients mean. For example:

- Are transactions which have not been completely processed presented as if they are complete?
- Are custody assets presented separately from those subject to a charge in favour of the failed firm?
- How are Title Transfer Collateral Arrangements ('TTCA') assets presented?

8.56 I doubt if mandatory standardisation is practicable (or desirable) and it would in any event be too prescriptive.

8.57 I recommend however that a firm's CASS resolution pack should contain a detailed explanation of how client statements are presented.

8.58 In addition, it is important that the particular methodology used by a firm be clearly set out as part of the client statement or the notes to it.

Restrictions on Status Changes ("Switching")

Restrictions on Status Changes ("Switching")

- 32 Clarity regarding status of professional clients who, having contracted out of CASS, seek to switch back from unsecured creditor to client status, to maximise their protection. Switching only to be allowed to take place after the firm's records (and if necessary transfers between firm and client accounts) has been updated to reflect the client's change to protected client status.

8.59 Professional clients may contract out of the CASS regime. This may occur for example if they borrow from the investment firm and use their asset portfolios as security for their borrowings. This means that their relationship with the firm will (at least in part) be that of an unsecured creditor, and no longer that of a client whose assets are segregated as Custody Assets. A feature of some firm failures which has contributed to complications and delays in returning Client Assets generally is an understandable desire by such clients, if they sense the firm is in trouble, to maximise their protection, notably by switching back from unsecured creditor to client status. The FCA CP 13/5 highlights this point at paragraphs 4.20-4.24 and proposes to formalise the process of any switching of status. I share the view that there should be more clarity around such shifts and that these should only take place after the firm's records (and if necessary transfers between firm and client accounts) have been updated to reflect the client's change to protected client status.

8.60 In the absence of FCA rules or of clear contractual provisions, there may currently be uncertainty as to what is required for a client's switching of its status to take effect. A large number of status switches at the same time is likely to impair the accuracy of a firm's records, particularly at a time of general stress for the firm. The uncertainty this produces when an Administrator seeks to ensure the failed firm's records are up to date can have a knock on effect on other clients because the Administrator is likely to need to be able to have an overall perspective of client entitlements.

Electronic communication

Electronic communication

33 Administrator should have power to communicate with clients using email.¹⁵

8.61 It seems an anomaly that an Administrator does not have power not to communicate with clients using email, as it would clearly improve efficiency and reflect standard business practice. I now understand better the issues which may have arisen here. The SAR regime consists of the underlying regulations¹⁶, plus a series of SAR rules¹⁷ which contain much of the technical and administrative detail which applies to the conduct of a SAR. The SAR rules were based on the rules applicable to administrations generally at the time they were promulgated. However, I understand that the general insolvency rules were modified and streamlined after the SAR was introduced. These modifications do not apply to the SAR rules.

Close Out Power

Close Out Power

34 Administrator should have power to unilaterally to close out open positions on unhedged options or futures contracts, etc.

8.62 One of the early agenda items for any Administrator when appointed is to identify sources of continuing risk (in terms, for example, of increasing liabilities) and to seek to reduce or eliminate them, so far as possible. In the case of a failed investment firm, one source of ongoing risk is in relation to open positions on, for example, unhedged options or futures contracts. The Administrator's instinct will generally be to seek to close them out at the earliest opportunity. However if these contracts were entered into for the account of clients, the Administrator may not be able to close them out without client consent. I recommend that Administrators should be given the power unilaterally to close out all or any such contracts following appointment. This would have the added advantage of aligning close out cost or value to the notional figures used under CASS for calculating client entitlements to the CMP.

¹⁵ This recommendation corresponds to that outlaid in Recommendation 7, on page 30 of my Interim Report.

¹⁶ The Investment Bank Special Administration Regulations 2011 (SI 2011/245).

¹⁷ The Investment Bank Special Administration (Scotland) Rules 2011 (S.I. 2011/2262) (S.3).

Insolvency rules

Insolvency rules

- 35 Review general insolvency rules (and any future amendments) to consider what aspects should be reflected in SAR Regulations or rules.¹⁸

8.63 I also recommend that a review should be carried out of the SAR rules to consider what aspects of the current general insolvency rules, including any further modifications which may be under consideration, could usefully be imported into the SAR rules. Going forward, whenever generally applicable insolvency rules are under review, consideration should be given to whether any reform should be extended to the SAR Rules (or, indeed, to the insolvency rules applicable to any other special regimes in the insolvency sector). In this connection, I note that the Insolvency Service is currently engaged in a process of modernising the general insolvency rules. (See 'Future proofing' below).

Future proofing

Future proofing

- 36 Establish a mechanism for regular monitoring of changes in transaction structures and firm operations and consider what updates of the CASS Rules (or regulation more generally) or the SAR may be called for.

8.64 I have been struck, in carrying out this review, by the variety of scales and business models (and therefore underlying contractual relationships and processes) of investment firms to which the SAR can apply and also by the ingenuity deployed by some firms in developing structures to address particular client demands or to reduce their own counterparty risk exposure.

8.65 In addition, there is the prospect of legislative and regulatory developments at domestic and international levels which may impact on business models and structures.

8.66 It can sometimes be that the full implications of reforms are only apparent when they come to be applied. EMIR may be a case in point.

8.67 It must therefore be a challenge for any regime, be it regulatory or part of the insolvency law framework, to be capable of adapting so as to address these evolving business practices.

8.68 I therefore consider that there is a case for having some form of standing review body both to monitor changes in business transaction structures and operations and to consider what updates of the CASS Rules (or regulation more generally) or the SAR may be called for. This may be one method of promoting one of the Act's objectives for the SAR, namely to maximise, on an ongoing basis, the efficiency and effectiveness of the financial services industry in the United Kingdom.

8.69 One development on the horizon at the EU level is the Bank Recovery and Resolution Directive (BRRD). Once this is finalised, I recommend that consideration be given as to how (if at all) the SAR and the BRRD will interact and whether any further changes to SAR are required. It may be that in the investment firm sphere, the BRRD will principally impact those which are or

¹⁸ See section on Electronic Communication.

may be systemic, for which the expanded SRR regime has been created under the Financial Services Act.

EMIR

EMIR

- 37 Consider how the interaction of EMIR and SAR rules would work in a firm failure, so as to seek to identify uncertainties and frictions between them and amend the SAR rules accordingly.

8.70 It is possible that the introduction of EMIR and its porting provisions may introduce new uncertainties into the regime of holding and dealing with Custody 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.

8.71 EMIR is directly applicable to UK law, such that as soon as the date for entering into force occurs, the relevant provisions apply without the UK needing to specifically legislate for them. For our purposes, this now means that central counterparties are required to make efforts to 'port' a client's positions (including margin) to another market participant in the event of failure of a firm.

8.72 There may be cases where it proves possible to port the positions of some clients but not of others. This is likely to produce a better outcome for the ported clients than for the clients whose positions are not ported.

8.73 Initially, I wondered whether this required a modification to insolvency law (and therefore the SAR), because it might be argued that the ported client was being preferred over other clients whose positions were not ported. This outcome could contravene the general *pari passu* principle of UK insolvency law. However, I have concluded that, as this is mandatory and provided this is a term of the statutory trust under which Client Money (including those monies subject to porting) is held, the outcome arises outside the operation of insolvency law and so no question of legal preference applies, even if there may be perceived to be unfairness.

Scope of SAR

Scope and title of SAR

- 38 Insurance brokers should continue to be excluded from the scope of the SAR.

8.74 Part of the scope of the Terms of Reference involves my considering whether the SAR captures the right population of firms.

8.75 The Act defines which entities are susceptible of being subject to the SAR. The scope of the SAR applies to "investment banks", as defined. There are a number of prerequisites. One is that it must carry on a specified regulated activity. The other distinguishing feature is that the firm must receive and hold "Client Assets".

8.76 The statutory definition is broad enough to include a number of firms which are not, functionally, investment firms or deposit taking banks. An example is an insurance broker. I understand that a decision was taken before the SAR was introduced that it was not intended, as a matter of policy that the SAR should apply to such firms. Accordingly, the definition of “investment bank” used for the purposes of the Act was amended to exclude insurance brokers. It has not been possible to procure materials which explain this decision. However, I consider that it is a sensible one, for the reasons set out below.

8.77 Whilst insurance brokers may hold substantial amounts of Client Assets and in particular Client Monies at any one time, one should expect that these monies would not typically be held for long periods of time. In the case of premiums paid by the insured, these transit via the broker on their way to the insurer. If insurance claims are paid by the insurer via the broker, again the broker ought to pass them on to the insured (or any assignee of which they have notice) without delay. A SAR regime which required premiums to be paid back to the insured rather than to the insurer might have the effect of entitling the insurer to terminate the insured’s policy. It therefore seems to me that issues relating to Client Monies held by insurance brokers are different from those relating to Client Assets held by investment firms.

8.78 Plainly the key going concern regulatory policy requirement is to ensure that Client Monies held by insurance brokers are segregated and identifiable (both as against the firm and as between different clients), as well as that unjustified delays do not occur in remitting them to the person entitled to them.

8.79 If an insurance broker goes into an insolvency procedure, it may be necessary for the Administrator to seek a Court order giving them standing to handle Client Assets and to defray associated costs out of the Client Assets, as they would not have the benefit of the SAR’s Objective 1.

8.80 Accordingly, I consider that the current scope of the SAR is appropriate.

LBIE & MF Global judgements

Lessons learned

- 39 Compare overall outcomes for LBIE & MF Global clients and creditors, once cases complete, to ensure all applicable lessons are learnt from them.

Review of outcomes

- 40 FCA, HM Treasury and the Insolvency Service together consider implications of the MF Global judgments:
- a Whether any of the outcomes in the MF Global cases should be codified in the SAR or the applicable Rules.
 - b Whether the outcome reflects the collective policy intention at the time the SAR was introduced, or would have done so if the particular fact pattern of which MF Global is representative had been considered at the time.
 - c Whether and how best to remove the anomalies in the drafting of the SAR identified by the MF Global decisions.
 - d An exercise should be carried out to identify whether there are any other anomalies between client entitlements under CASS and their creditor claims under SAR.

8.81 Neither of the two major UK investment firm insolvencies (LBIE and MF Global) are yet complete, on either side of the Atlantic.

8.82 It will certainly make sense, once these are substantially complete, to carry out an exercise to compare overall outcomes for clients and creditors, so as to make sure that all possible lessons have been learned from those cases. Perhaps this would be a useful exercise involving Treasury, FCA, the Insolvency Service, the Administrators and any willing interested parties.

8.83 I also recommend that FCA, HM Treasury and the Insolvency Service should together consider the implications of the MF Global judgments:

- Whether any of the outcomes in the MF Global cases should be codified in the SAR or the applicable Rules.
- Whether the outcome reflects the collective policy intention at the time the SAR was introduced, or would have done so if the particular fact pattern of which MF Global is representative had been considered at the time.
- Whether and how best to remove the anomalies thrown up by the drafting of the SAR and the MF Global decisions.

G. Role of the Courts and dispute resolution

Consider:

Fast tracking and other proposals

- 41 LJ Briggs' recommendations, including fast-tracking determinations of major issues in large insolvencies.

Operational implications of issues in dispute

- 42 Courts to be given presentations on operational aspects of disputes, practical implications of particular legal outcomes, and so on.

Alternative dispute resolution methods

- 43 Exploring alternative methods of speeding up reaching determinations of the legal issues which will inevitably arise in complex investment firm insolvencies.

FCA power to make determinations

- 44 As an alternative to Court, an FCA power to make binding rulings on points unclear or not covered by CASS, in individual cases.

Court power to allow payment of Client Asset costs out of Firm Estate

- 45 The Courts to be given power, through the SAR, to direct that some Client Asset costs can be paid out of the Firm Estate if the failed firm's conduct prior to failure has resulted in increased costs. Guidelines should be drawn up as to the circumstances where this would be appropriate.

8.84 A number of the contributors to the review encouraged me to give thought to the role of the Courts in SAR cases. It was also suggested that existing Court procedures were not the best forum in which to bring to the attention of the Courts the practical and operational complexities underlying issues requiring judicial determination when a firm fails.

8.85 In the LBIE and MF Global administrations, the Courts have had a significant role in deciding issues, with the resultant delays and sizeable costs depleting the relevant pool of Client

Assets. It is to be hoped that future SAR cases do not require as much Court intervention, with the regime having been clarified by the Courts, improved by the FCA and assuming that the SAR is updated.

8.86 One of the judges who has been most involved in first instance decisions in relation to LBIE is Lord Justice Briggs. Their decisions, and those of other Courts, illustrate the advantages of the assigned judge system for cases such as LBIE and MF Global. Lord Justice Briggs delivered the Denning Lecture in 2012.¹⁹ This contained a very thoughtful reflection on the outcomes of cases heard to date in the LBIE administration. It also made an argument for a fast track process to determine major issues arising in large insolvencies such as Lehman.

8.87 I support this suggestion. One other way of achieving some measure of more rapid finality might be to facilitate the process of leapfrogging cases involving points of major importance from first instance to the Supreme Court.

8.88 Cases such as LBIE and MF Global reveal transactions and practices of considerable complexity with which the Courts cannot necessarily be expected to be familiar. This, and the practical problems which have arisen out of the majority Supreme Court decision in LBIE to apply the claims basis²⁰ as the method of calculating client entitlements, indicate that it might be helpful for Courts to have access to independent presentations as to the operational aspects of disputes which arise, or the practical implications of particular legal outcomes. It may be that these could be made available to Courts handling complex SAR cases under the aegis of the Financial Markets Law Committee, which already has a programme of judicial seminars.

8.89 I recommend that the Treasury, in conjunction with the Ministry of Justice, consider these proposals. Consideration should also be given to identifying alternative methods²¹ of speeding up reaching determinations of the legal issues which will inevitably arise in complex investment firm insolvencies, and cutting down the resultant costs.

8.90 Consideration should be given as to whether the FCA should be empowered to make binding rulings on points unclear or not covered by CASS, which arise in particular cases of failed investment firms. This would be designed as an alternative to going to Court, although I recognise that there may be a risk of a FCA decision being subject to judicial review, which would cause delay to the progress of the administration.

8.91 In the context of speeding up Court processes, I note that Mr Justice Richards has contributed to the reduction of delays caused by unavoidable litigation in the MF Global case by producing his judgments with exemplary promptness.

¹⁹ See: BACFI: The Denning Lecture 2012 :“Has English Law Coped With The Lehman Collapse” By Lord Justice Briggs

²⁰ This means the participation in the CMP based on the amount which ought to have been segregated at a Primary Pooling event, as opposed to the amount of client money which had actually been segregated at the Primary Pooling event (otherwise referred to as the ‘contributions basis’).

²¹ Time has not permitted me to consider, for example, whether the City Disputes Panel could play a useful role in providing an alternative forum.

H. Some more general recommendations

Recommendation derived from Chapter 5

Administrator power to top up Client Money shortfalls from firm funds where Client Monies not paid into client accounts prior to the firm's failure.

- 46 Where firms use the 'Alternative Approach' to temporarily pay client monies into a general firm account, there should be a mechanism allowing the Administrator to transfer out of credit balances on firm account sums which they consider to reflect the proceeds of payments made by clients, or by third parties for the account of the firm's clients, into a firm account and not transferred into a client account prior to the failure. If this recommendation is adopted, the authorities should consider both whether the Administrator can do this off their own accord, or should require the court consent and whether this "top up" principle should have wider application than just where firms adopt the "Alternative Approach".

8.92 This recommendation is further discussed in Chapter 5.

Recommendations derived from Chapter 6

FCA powers

- 47 FCA and Treasury should identify legislative constraints under which FCA works in this area to consider whether to empower FCA to operate a more effective regime to protect Client Assets in going concern mode and also on the failure of an investment firm.

Codification

- 48 Any codification of CASS Rules should provide an alternative mechanism to the outcomes of Court decisions that are considered unworkable, e.g. by providing a regulatory alternative or substitute to Tracing.
- 49 Codify the existing CASS regime as now elucidated by LBIE Court judgements.

FCA CP 13/5 and Speed Proposal

- 50 FCA involves experienced Insolvency Practitioners, in-house Client Asset specialists at investment firms and expert financial services and insolvency lawyers in formulating any rules relating to the FCA's Speed Proposal if introduced.
- 51 If the FCA implements 'Speed Proposal', consider mechanism for FCA to "bless" Administrator's conclusion that Speed Proposal can be pursued, as it is reasonable to determine client entitlements from firm records.

Buffer

- 52 Support use of buffer for insolvency expenses.

8.93 These recommendations are further explained in Chapter 6.

Segregation/multiple pools

Segregation/multiple pools

- 53 Create regulatory requirement for clear “virtual” segregation in a firm’s records between securities purely held on a custody basis and others, such as those which may be charged back to the firm.

8.94 The FCAs’ CASS review has already initiated a debate on the topic of multiple pools and Client Money. I do not propose to comment on this in any detail for the purposes of this Report, 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.

8.95 One of the topics discussed by the FCA CP 13/5 is the question of introducing ‘multiple pools’ for Client Money. The FCA proposes to allow firms to segregate Client Money into discrete pools in order to facilitate any eventual transfer using porting arrangements under EMIR.

8.96 The FCA had previously canvassed views on a greater degree of permitted segregation. A number of commentators were concerned that the additional complexity this would create would give rise to operational risk or errors and this might lead to more disputes if a firm failed. I can see the force of this argument.

8.97 Nevertheless, I remain concerned that there is a risk that the return of the assets belonging to a straightforward custody client owing nothing to the failed firm might be delayed by the need to resolve much more complex issues surrounding a professional client’s holding of the same class of fungible assets. If the risks associated with actual segregation are too high, I recommend that, at least, there should be a regulatory requirement for clear “virtual” segregation in a firm’s records between those securities which are purely held on a custody basis and those, for example, which may be charged back to the firm.

Fundamental Review of Law

Fundamental Review of Law

- 54 Consider need for radical review of law under which client entitlements can arise in UK Client Asset protection regime, and whether appropriate to rely on property, trust and insolvency law concepts, in context of fast moving and intangible rights of modern and sophisticated investment markets.

8.98 In a commingled fund, particularly if there are shortfalls, the CASS regime and 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. As mentioned in Chapter 5, I consider that an exercise should be conducted to consider the merits or otherwise of a move to a standalone mechanism for defining and determining Client Asset entitlements.

Use of Schemes of Arrangement

Use of Schemes of Arrangement

- 55 Consider whether Schemes of Arrangement scope could be expanded to deal with proprietary claims and overseas law governed contracts.

8.99 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” test²² being met).

8.100 A scheme of arrangement is a compromise between a company and its creditors. If approved by the majorities specified in Part 26 of the Companies Act 2006 and subject to approval by the Court, the compromise becomes binding on all creditors affected by the scheme. This is commonly used in restructurings and is a very flexible process which can be implemented relatively rapidly.

8.101 There may be circumstances in which the SAR procedure (and in particular the Bar Date process) is not the most speedy or cost effective method of achieving, in broad terms, the best (and desired) outcome for the overwhelming majority of clients. In this connection, there may be merit in allowing an Administrator to promote a scheme of arrangement (requiring of course a suitable majority of clients and Court sanction in the normal way) in relation to the overall Client Asset or Client Money pool as an alternative to using the Bar Date and other mechanisms prescribed by the SAR. I recognise that this would require legislation to overturn the judgment in LBIE²³, where it was held that the legislation does not permit a scheme of arrangement to be used to compromise the sorts of proprietary rights clients have against the failed firm.

8.102 In LBIE, the Administrators have been able to use bilateral contracts with accepting clients to achieve the same result (for accepting clients) as a scheme would have delivered, but this will have taken much more time and cost considerably more than a scheme of arrangement.

Different regimes

Different regimes

- 56 Consider justification for differences between SAR and SRR regimes mechanics and whether any aspects that are needlessly different can be streamlined.
- 57 Produce a guidance note on the factors which are likely to determine which (of the three regimes) is selected in any particular case. This might also comment on the respective roles of the FCA and PRA in different cases.

8.103 There now exist three possible insolvency regimes into which a failed investment firm can fall:

- “ordinary” insolvency;

²² Schemes of arrangement are part of English company law, but their availability is not limited to companies incorporated in England and Wales. The courts do, however, require that there be a sufficient connection between the company (or the obligations the subject of the proposed scheme) and the English jurisdiction. Typically, this will be that the obligations are governed by English law, are in an agreement which confers jurisdiction on the English courts or are owed in some significant measure to English creditors. The courts will also enquire as to the prospects that the proposed scheme will be recognised or effective in other relevant jurisdictions.

²³ See *In re matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 and in the matter of the Companies Act 2006* [2009] EWCA Civ 1161 (Court of Appeal, 9 November 2009), upholding the judgment in [2009] EWHC 2141 (Ch) (High Court, 21 August 2009).

- SAR;
- The SRR for systemic investment firms.

8.104 The protections afforded by CASS will apply whichever regime is selected.

8.105 I concluded in my Interim Report that 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.

8.106 In addition to this more general recommendation, that there be produced a guide to the multiplicity of special insolvency regimes and the differences between them, I consider that it would also be useful to:

- Make sure that the differences which exist between the regimes reflect essential functional distinctions between the objectives of the regimes and that consideration is given to any aspects that are needlessly different to see whether they may be streamlined, with the best provisions adopted across all the procedures. In particular, there may be aspects of the SRR regime in relation to achieving transfers of business which could usefully be adapted to the SAR (without of course involving any call on public funds).
- Produce a guidance note on the factors which are likely to determine which regime is selected in any particular case.

FCA/PRA roles

FCA/PRA roles

58 Guidance Note on FCA/PRA Roles in SAR cases.

8.107 Since the SAR was established, the single regulator (the FSA) has been replaced by the PRA and the FCA. It is important, in order to ensure the smooth running of a SAR case, that each regulator understands its ongoing role (if any), and that the Administrator knows with which regulator they need to engage on any particular point.

8.108 This applies particularly if it is necessary to determine at the outset whether the particular failing firm is or is not systemic.

8.109 I recommend that the FCA and PRA publish a guidance note clarifying how they see their respective roles in this area.

Recommendation derived from Chapter 7

Industry funded compensation scheme

- 59 Canvass stakeholder views on more generous industry funded compensation scheme to top up FSCS protection.

8.110 Further discussion of this recommendation can be found in Chapter 7.

Non EMIR “porting”

Non EMIR “porting”

- 60 Consider the SAR expressly recognising lawfulness of non EMIR powers of trading exchanges unilaterally to close out and make substitutions (including using failed firm collateral) in respect of client positions if counterparty fails. Alternatively, make clear that such transactions, to the extent they are carried out for market integrity reasons, have protection under Companies Act 1989, Part VII.

8.111 EMIR has focussed attention on porting and that regulation contains provisions necessary to deal with it. In addition, the FCA CP 13/5 contains provisions designed to facilitate holding and use of client monies in connection with porting in that context.

8.112 There may, however, be other instances of transactions similar to porting under EMIR which affect a failed firm. In particular, trading exchanges may, in accordance with their duties to other clients and the markets in which they operate, have rights unilaterally to close out and make substitutions in respect of client positions if a counterparty fails. These may be positions where the client is trading, vis a vis the failed firm, as a client or where the transactions are carried out on a TTCA basis.

8.113 In the latter case, the porting may entail the use of funds belonging to the failed firm’s estate (i.e. outside the Client Money pool) to achieve the porting. Such a transaction, which may take place without the Administrator’s consent or power to prevent it, may raise novel issues under insolvency law. I recommend that consideration be given to building into the SAR provisions expressly recognising the lawfulness of such transactions. An alternative may be to make clear that such transactions, to the extent they are carried out for market integrity reasons, have protection under Companies Act 1989, Part VII.

Cooperation guidance

Cooperation guidance

- 61 Update ‘*Cooperation Guidance between Recognised Bodies and Insolvency Practitioners To Assist Management Of Member Defaults By Recognised Bodies*’ with comments from FCA, professional and trade bodies.

8.114 During the course of my review, my attention was drawn to a document entitled ‘*Cooperation Guidance between Recognised Bodies And Insolvency Practitioners To Assist*

*Management Of Member Defaults by Recognised Bodies (Recognised Clearing House version)*²⁴

This document could serve a useful purpose and I recommend it be updated and given to a wider circulation for comment, including by the FCA, professional and trade bodies

8.115 I understand that there is an initiative under way to seek to put in place a form of best practice protocol to operate at international level. If this can be achieved, even so as to encourage co-operation in provision of information and acceleration of return of Client Assets held overseas, it is to be welcomed.

Data aggregator

- 62 Consider merit of a single aggregator of data which might assist an Administrator, as well as regulatory authorities.

8.116 The fact that many categories of trade can now be carried out using different and competing infrastructures means that no one entity will necessarily have an overview of all the failed firm's trades in particular markets. Consideration should be given to whether there is any merit in having a single aggregator of data which might assist an Administrator, as well as regulatory authorities.

Requirement for review

Requirement for review

- 63 Removal of requirement for review of SAR investment firm insolvency regulations each time the Treasury makes new regulations pursuant to section 233 of the Act. Alternatively, a simple report could be required to be delivered to Parliament rather than a full independent review.

8.117 Currently, each time the Treasury makes modifications to the SAR insolvency regulations, pursuant to section 233 of the Act, they are required to arrange for a review in to the effect of those modifications. Consequently, this requirement will apply to any modifications to SAR resulting from my review. This results from the interpretation of the Act, although one may wonder whether this was the intention of the legislators. This duty to arrange a review of those regulations must be satisfied within two years of them being made. There were only three SAR cases within the two year period since its inception. It may be that in future, there may be none within that same time period.

8.118 I recommend the removal of the current requirement altogether, because it would be better to spend the resources on ensuring the SAR is kept up to date. I understand that any legislative amendment to SAR would be effected either by primary legislation or by secondary legislation using the affirmative resolution procedure. It seems to me that either process would afford an opportunity for Parliament to consider at the time the appropriateness of the reform under contemplation, so that a subsequent review would not be called for. If this is thought unacceptable, I would recommend instead a simple report be required to be delivered to Parliament rather than a full independent review.

²⁴ <http://www.bankofengland.co.uk/financialstability/Documents/fmi/Insolvency%20practitioners.pdf>

Title of SAR regulations

Title of SAR regulations

- 64 Amending the definition in the Act and title of SAR regulations so they do not refer to 'investment banks'.

8.119 One practical point which has cropped up in my consultations is that the use of the term "investment bank" may cause confusion as to the scope of the SAR. This terminology derives from the definitions used in the Act and, as a result, in the title of the SAR. None of the SAR cases to date have been "banks" in the conventional sense. If any legislative changes are proposed, it would make sense to amend the definition so as to refer to "investment firms".

Creditors' committees

8.120 In my Interim Report, I recommended 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 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. (See Chapter 5 of my Interim Report for further discussion).

8.121 The aim of this proposal was to try to provide an alternative method of resolving uncertainties arising in the course of the administration of the failed firm, instead of the inevitably much slower (and more expensive) process of going to Court for directions. Having considered this further and had the opportunity to discuss it with Administrators, I have concluded that this proposal is problematic, for three principal reasons:

- 1 The proposals would be seen as imposing responsibilities on members of the creditors' committee. Although the make-up of a creditors' committee is designed, so far as possible, to be broadly representative of the overall make up of clients and creditors of a failed firm, individual members are entitled to express views and exercise rights in the interests of their firm or "constituency". They do not have any overriding duty to consider the overall best outcome for clients or creditors generally.
- 2 Introducing such provisions might imply that members had responsibilities to the estate or to other clients or creditors. This might reduce the pool of candidates for creditors' committees.
- 3 In cases where there is a considerable amount of debt trading, the composition of the creditors' committee may fluctuate, rendering it less suited to providing the sort of steer to the Administrator that the proposal in the Interim Report contemplated.

8.122 Consequently I have abandoned this proposal.

8.123 The consequence of this is that, in cases of difficulty or uncertainty as to client entitlements, there are likely to be only two alternatives:

- 1 A Court directions process (see the discussion above on the role of Courts); or
- 2 A ruling by the FCA, if this recommendation is feasible and is adopted.

I. Behavioural recommendations

8.124 The Interim Report contained a section (paragraphs 5.31 to 5.38) on what I called Behavioural Recommendations. I continue to advocate these. For convenience, they are reproduced on page 75. Many are conduct related, notably in terms of record keeping. They are broadly in line with some of the proposals in the FCA CP 13/5.

8.125 If the Speed Proposal is adopted, quality of records will of course be even more important to a rapid, satisfactory and fair outcome for clients of a failed firm.

9

Next steps and implementation

9.1 As made clear in the Terms of Reference, this review needs to work in tandem with the FCA's own review of its CASS rules.

9.2 The FCA published its own consultation document on proposed reforms in July. The FCA consultation period extended until 11 October 2013. Following that consultation, I am aware that the FCA is keen to announce its definitive CASS reform proposals at the earliest opportunity in 2014.

9.3 It will be necessary to ensure that my recommendations (to the extent accepted) and any FCA proposals that result from the CP 13/5 work well in tandem.

9.4 HM Treasury will now need to consider which of the recommendations in this report it proposes to accept. I expect that a further consultation will follow, particularly for those recommendations that would result in a more radical, or fundamental change to the current arrangements.

9.5 I recognise that it is important to ensure that, overall, any reforms to the SAR and indeed to CASS have a result which is proportionate in terms of the objectives to be achieved. These include of course the explicit objective in the Act to maximise the efficiency and effectiveness of the financial services industry in the UK.

10

Conclusion

SAR conclusion

10.1 No legislative or regulatory regime can, or, arguably, should, prevent failures of investment firms. So the regulatory and insolvency regimes should, between them:

- 1 Protect Client Assets and in particular not expose them to the firm's general liabilities;
- 2 Place emphasis on compliance with the regulatory measures to protect Client Assets in "going concern";
- 3 Remove, so far as possible, obstacles to a rapid and cost effective transfer or return of those assets following a firm's failure; and
- 4 Ensure an adequate degree of fairness among clients and between clients and other creditors, recognising that clients have special protections designed to improve their outcomes (compared to other creditors) if the firm fails.

10.2 Achieving this calls for clear, comprehensive and adaptable regimes, and CASS and SAR regimes which work effectively together.

10.3 Because firms will, and must be allowed to, fail, the existence of a sound and predictable mechanism for dealing with failures of a firm is an important component of an economy's competitiveness. Following the financial crisis, there is increased international focus on how financial sector failures are handled from one country to another and on the results of firm failures in different jurisdictions.

10.4 The UK has already taken a considerable number of initiatives to enlarge the range of remedies available to it to address failure in the financial services sector. These include the regimes applicable to systemic firms (including systemic investment firms following the passage of the Financial Services Act 2012) as well as the SAR itself. UK policy is reflected at EU level in many aspects of the proposed BRRD.

10.5 Just as failures are inevitable, so are specific and novel problems or uncertainties in individual instances of firm failures. These may be practical ones (poor records) or legal uncertainties. It is not the role of the Administrator to decide themselves on the answer to legal uncertainty, although they may be able to propose a compromise with individual creditors or with creditors generally (subject to the limitations under current law on the use of Schemes of Arrangement to compromise or extinguish proprietary rights).

10.6 Such legal uncertainties will fall to the Courts for decision, unless there is an alternative mechanism, such as a power for the regulator to consider and impose an unimpeachable solution.

10.7 The SAR was a first attempt, in the wake of the Lehman crisis, to adapt general insolvency law to create a bespoke procedure for investment firms. Now that it, and the CASS regime which underpins Client Asset protection, have been put to the test, a number of lessons have been learnt.

10.8 It is clear that, whilst the SAR provides a useful framework for the handling of the affairs of a failed firm and in particular dealing with Client Assets, there are improvements which could and should be made.

10.9 I hope that this two stage review has helped to identify what needs to be done now to enhance the UK's Client Asset regime for protecting Client Assets held by investment firms in going concern mode and rapidly transferring them in gone concern mode.

10.10 Even if all the recommendations in this report are implemented, future firm failures will show the SAR to be imperfect, because it cannot forecast what complexities or novel problems will arise in the future. Legislation is static, whereas markets are always changing. For this reason, regular ongoing monitoring of both CASS and SAR is desirable so that they remain fit for purpose in the changing marketplace.

10.11 I hope that a combination of reforms of CASS, operational improvements in going concern mode and changes to the SAR should, nevertheless, serve to improve the overall effectiveness of the Client Asset and SAR regimes when an investment firm fails. Reforms in this area will make further progress towards achieving the goals stated in the Act of "minimising the disruption of business and markets" and "maximising the efficiency and effectiveness of the financial services industry in the United Kingdom" in the context of failures of investment firms.

A

Terms of reference

A.1 The review must consider, in particular:

- 1 how far the regulations are achieving their objectives (specified in section 233(3) of the Act 2009); and
- 2 whether the regulations should continue to have effect.

A.2 In addition, the review must consider what other changes to law or practice, if any, would better deliver the objectives of the SAR.

A.3 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.

A.4 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.

A.5 The review should take account of the consensus reached in the creation of the SAR, building on the earlier public consultation on the SAR.

A.6 The review must be delivered in co-ordination with the FSA's review of its own Client Assets

A.7 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.

A.8 The review must engage fully with stakeholders, including, but not limited to, the FSA, the Bank of England, the Insolvency Service, Administrators, 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

A.9 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.

A.10 The review should consider whether the scope of the SAR is appropriately defined and whether it captures the right population of firms.

A.11 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.

A.12 Comparisons may be made to the equivalent processes in other countries, for example the US.

A.13 The assessment will include how effective the regulations have been in minimising any disruption to business arising from insolvency, and in maintaining the UK as a global centre for financial services.

A.14 Examples of the type of measure that the review could consider include, but are not limited to:

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

A.15 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

A.16 The review will be split into two phases.

A.17 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.

A.18 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.

A.19 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.

A.20 The second phase will deliver the work programme, in accordance with the Terms of Reference set out above.

A.21 The Terms of Reference apply in full to the second phase.

Outputs

A.22 Present a written report to Ministers by 7 February 2013, comprising:

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

- 4 Present a second written report to Ministers comprising:
- 5 Recommendations about how the regulations could be improved;
- 6 Recommendations about whether the regulations should be replaced;
- 7 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.
- 8 Recommendations about further work required to deliver any further assessment of these options.

A.23 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

Behavioural recommendations from Interim Report

Behavioural recommendations¹

- 65 Good record-keeping essential: Some firms need to improve quality of records. Practices of reconciliation of firm and client or counterparty records need to be enhanced.
- 66 Clients should be encouraged to review statements received from firms.
- 67 Consider standardisation of the data supplied or notes provided particularly ongoing transactions.
- 68 Firms to make sure clients (especially retail clients) should be able readily to understand contents of client statements, particularly in relation to the status of ongoing trades. Regulators should ensure this.
- 69 Client asset and money rules need to be fully understood by both regulators and regulated.
- 70 Firm's intra-group relations need to be clear and transparent: firms should remove any ambiguities in their intra-group contractual and entitlement arrangements. Regulators should focus on this and consider whether CASS resolution packs for groups should contain copies of the principal long term intra-group agreements.
- 71 Improvements to communications should be considered: FCA, 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. The complexities of the circumstances in which FSCS may be able to provide compensation would be one example.
- 72 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.

¹ Recommendations 65 - 72 outlined above refer to the Behavioural Recommendations that I have previously discussed in my Interim Report.



Glossary and acronyms

Acronyms

Acronym	
BRRD	Banking Recovery and Resolution Directive
CASS	FSA's Client Assets Sourcebook
EMIR	European Market Infrastructure Regulation
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
HMRC	Her Majesty's Revenue and Customs
ISA	Individual Savings Account
LBIE	Lehman Brother International (Europe)
SAR	Special Administration Regime
SIPA	The US Securities Investor Protection Act 1970

Glossary

Term	Definition
The Act	The Act, also known as the Banking Act 2009, was passed through Parliament following the collapse of the Lehman Brothers. The Act established a permanent statutory regime for dealing with failing banks; amended existing legislation and made new provisions for the governance of the Bank of England.
Administrator	An Administrator in the context of this report refers to any person appointed by the Courts to implement an administration order under the SAR.
Alternative Approach	Under the Alternative Approach, as set out by the FCA, Client Money can be received and paid out from a firm's own bank account as opposed to the client bank account. This approach was designed to be used for firms for whom the normal approach leads to greater risks to Client Money than the Alternative Approach, typically for large firms operating in multiple jurisdictions.
Bar Date	The SAR bar date mechanism refers to the provision in the SAR for an Administrator to set a cut-off date for the claiming of the client assets held by the investment bank. The difference between "soft" and "hard" bar dates is discussed in Chapter 8, paragraph 8.16.
CASS Resolution Packs	The CASS Resolution Pack was published in March 2012 by the FSA in PS 12/6. CASS Resolution Packs ensure that information and records that would help an Administrator in the event of their failure would be more accessible. The benefit of this arises from being able to return Client Money to clients more swiftly.
CASS Rules	CASS Rules are the FCA rules applicable to firms in relation to client money and custody assets held and received in connection with investment business and insurance mediation activity.

CCP (Central Counterparties)	A central counterparty is an entity that interposes itself between counterparties to contracts traded on one or more financial markets, becoming the buyer to every seller and the seller to every buyer. In this manner a central counterparty acts to guarantee the obligations under the contract which reduces counterparty credit risk.
Client Assets	Refers to both Client Money and Custody Assets (see individual terms for further information).
Client Money	Client Money refers to a client's money held by a firm in connection with investment business (or insurance mediation activity). The holdings typically relate to sale proceeds, dividend income as well as money held as collateral for margined transactions. These holdings are kept separate from the firm's own account in client bank accounts. It should however be noted that under the Alternative Approach for client money segregation, Client Money is first received in the firm's own accounts before being deposited in the client bank account.
Client Money Rules	The Client Money Rules are the FCA rules applicable to firms in relation to client money held and received in connection with investment business (and insurance mediation activity). The FCA has consulted in FCA CP 13/5 on changes to these rules following a review. This consultation includes proposals that would, if made, materially change how client money is distributed in an insolvency.
Custody Assets	Custody Assets refer to clients' non-money assets held by a firm in connection with investment business e.g. shares, bonds and other instruments that are not cash but 'designated investments' as defined in FSMA (or the Regulated Activities Order) or a 'financial instrument' as defined in MiFID.
EMIR	The Regulation of the European Parliament and of the Council on OTC (over-the-counter) derivatives, central counterparties and trade repositories – commonly known as the European Market Infrastructure Regulation (EMIR) – is a piece of European Union legislation, stemming from a G20 agreement.
FCA CP 13/5	Consultation Paper 13/5 published in July 2013 by the FCA. This consulted on the proposed changes to the rules regarding Client Money, Custody Assets and other mandates. The purpose was to enhance the FCA's Client Assets regime.
FSMA	The Financial Services and Markets Act 2000, implemented in December 2001 primarily provides the FCA with a framework under which they have a range of statutory powers. Some of the firms typically falling under the scope of FSMA include banks, insurance companies, investment advisors and credit unions.
Hindsight Principle	The "hindsight" principle is a rule of insolvency law, designed to ensure that the return to an individual creditor approximates so far as possible their actual loss and that returns to creditors collectively are distributed as fairly as possible. As a general principle, each creditor's claim as an unsecured creditor is calculated at the outset of the insolvency. However, as result of the Hindsight Principle, account will be taken of events during the insolvency which impact on the value of the claim. The most obvious categories of claim affected by this principle are liabilities of the failed firm which are contingent at the onset of the insolvency process. During the insolvency process the contingency may occur, making it an actual liability, capable of more exact computation. Alternatively it may become clear that the contingency will never occur, so that there is no liability on the part of the failed firm.
Interim Report	This refers to the first part of my independent review on the SAR undertaken as instructed by the Treasury. Published in April 2013, it can be found at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/190983/peter_bloxham_review_of_investment_bank_sar2011_.pdf
Investment Firm	Although the term in the Act 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.

MiFID	Markets in Financial Instruments Directive (I), implemented in November 2007 by the FSA, as it then was, aimed to replace the ISD (Investment Services Directive), extend its coverage, and set out further requirements for the conduct and internal organisation of firms. There are currently proposals for MiFID (II) which aim to propose a single market for retail and wholesale transactions of financial instruments.
Primary Pooling Event	An event that occurs triggering Client Money held by the firm being pooled into a single Client Money pool.
Preference	The word preference means that the client or creditor would have a higher ranking (compared to other creditors of the failed firm) to receive payment or distribution in respect of their claims on the failed firm.
Prioritise	Prioritise denotes that there is a legal requirement to attend to that task at an early stage in the administration.
BRRD	BRRD (European Bank Recovery and Resolution Directive) sets out new crisis management tools to avoid future bank bail-outs. The proposals adopted by the European Commission will aim to help deal with cross border bank and domestic bank crises.
SAR Rules	SAR (Special Administration Regime) for investment firms came into effect in February 2011 and was set out in the Investment Bank Special Administration Regulations 2011 (SI 2011/245). This regime evolved following the onset of problems faced by the failure of LBIE. As a result, the SAR for investment firms was introduced, with the overarching objective to ensure minimal disruption to the wider UK financial industry.
Speed Proposal	The FCA is proposing to introduce a Client Money distribution regime that permits an initial distribution of Client Money on the basis of a firm's records. The proposal would introduce a two-stage Client Money distribution process. See FCA CP 13/5, paragraph. 2.3-2.31.
SRR (Special Resolution Regime)	The SRR (Special Resolution Regime) established in the Act, enables the UK to resolve failing banks; building societies; and since Financial Services Act 2012, investment firms; UK recognised clearing houses and banking group companies; where their failure would pose a threat to the stability of the UK's financial system. It provides the option for (a) the Bank of England to transfer the shares or some or all of a business of a bank to a commercial purchaser; (b) the Bank to transfer some or all of the business of a bank to a "bridge bank" wholly owned by the Bank; and (c) the Treasury to transfer the securities of a bank into temporary public ownership.
Title Transfer Collateral Arrangements	Title transfer collateral arrangements are arrangements by which a client transfers to a firm full ownership of monies or assets for the purpose of securing or covering existing or future obligations. These arrangements have the effect of removing a client's monies or assets from the protections offered by the FCA's Custody Rules and Client Money Rules.
Tracing	Tracing refers to a doctrine developed by the Courts, designed to facilitate identifying property (or its proceeds) beneficially owned by one person but which has passed into the legal ownership of a third party or which has been mixed with other fungible assets (such as money). This transfer can occur either innocently or dishonestly and the applicable legal principles recognise this distinction. The principles involved are complex, may differ according to the circumstances and many of them were developed to deal with property interests very different from the fluctuating and often dematerialised interests clients may have in investments in the financial markets. The doctrine is particularly relevant both to the FCA CP 13/5 and this review because the majority decision of the Supreme Court in LBIE, in adopting the "claims basis", effectively mandated a Tracing exercise, at least where a firm operates the Alternative Approach. However, one relevant feature of Tracing is that any monies which are paid into an overdrawn bank account cannot generally be traced further. As a result, Tracing is often in practice unavailable.
Schemes of Arrangement	A compromise between a company and its creditors in accordance with Part 26 of the Companies Act 2006.

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