HM Treasury

Reforms to the investment bank special administration regime

March 2016

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1 Introduction

1.1 Since the global financial crisis, the government has overhauled the system of financial regulation, as part of an international effort to address the problem of banks being "too big to fail". Through the Financial Services Act 2012, the government replaced the failed "tripartite" regulatory system with a set of regulators holding clear responsibilities and objectives; putting the Bank of England ("the Bank") at the centre of the new system, and making provision for collaboration between the Treasury and the Bank in relation to crisis management. The Financial Services (Banking Reform) Act 2013 legislated for the "ring-fencing" regime to separate banks' riskier investment activities from their retail banking activities. The UK has also implemented the Bank Recovery and Resolution Directive (BRRD), which provides a full set of resolution tools for banks, building societies and certain investment firms,[1] to ensure that the failure of a bank or investment firm can be managed in a way that protects the wider economy and financial sector.

1.2 The Investment Bank Special Administration Regime (SAR) was introduced in 2011. It was established in response to the fallout from Lehman Brothers, as the existing legislation exposed specific legal constraints for the resolution of large and complex investment firms.[2] Under the Banking Act 2009 ("the Act") the Treasury was empowered to introduce detailed regulations with accompanying insolvency rules, and these together comprise the SAR. The Act also required the regulations to be reviewed within 2 years of coming into force. Accordingly, the Treasury appointed Peter Bloxham to evaluate the regime, and his review ("the review")[3] was published in January 2014 and laid before Parliament.

1.3 The review recommended that the SAR should be retained, and proposed 72 reforms to strengthen the regime. These changes are intended to improve the speed with which assets can be returned to clients; provide greater legal certainty; improve the efficiency of the administration process; and consider the interests of both clients and creditors. The government fully supports the aims of the recommendations made in the review.

1.4 The government is grateful to Peter Bloxham for his work in reviewing the SAR, and by doing so, helping to ensure that the UK's resolution tools are effective. Furthermore, the government would like to thank the Banking Liaison Panel[4] for its assistance in developing these proposals.

1.5 The review's recommendations cover the SAR as a whole, including changes to the SAR Regulations and insolvency rules, which are made by the Treasury; and the Financial Conduct Authority's (FCA) Client Assets Sourcebook (CASS) rules. The Treasury, the FCA, and the Bank of England have therefore worked together to produce a set of proposals that respond substantively to the review's recommendations. This consultation document sets out the government's response to the review. Alongside this consultation, the FCA is publishing a discussion paper setting out their response to the review. It should be read in tandem with this consultation document.

1.6 The government accepts the substance of all the recommendations made in the review. The measures being proposed in this consultation document are largely technical changes that will

[1] Firms designated by the PRA would be likely be resolved using the stabilisation options under the special resolution regime, rather than enter the SAR.

[2] The Banking Act 2009 defines "Investment Bank" as an institution that has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on the regulated activity of (i) safeguarding and administering investments, (ii) dealing in investments as principal, or (iii) dealing in investments as agent.

[3] 'Final review of the Investment Bank Special Administration Regulations 2011', HM Treasury, January 2014

[4] The Banking Liaison Panel was established under section 10 of the Banking Act 2009 to advise the Treasury about the exercise of its power to make secondary legislation under the Act (such as the SAR), the Treasury's Code of Practice and any other matter referred to the Panel by the Treasury.

speed up and simplify the process of SAR administrations, bringing benefits to clients, creditors, and others involved in the insolvency process. In considering the review's recommendations, the government has given particular consideration to:

- the importance of simplifying and speeding up the SAR process to reduce costs to both clients and creditors
- the importance of ensuring any changes proposed provide legal certainty about the status of client and creditor claims
- the need to maintain consistency with the broader insolvency framework, including pre-existing insolvency procedures and CASS
- the need to provide for flexibility and future proofing
- the government's wider objective of protecting and promoting the reputation of the UK as a global financial centre

Structure of this document

1.7 This document sets out the government's response to the review, grouping the recommendations and the government's proposed response under 5 main chapter headings. The government's proposals are to be implemented by the draft regulations attached to this consultation paper, which amend the SAR Regulations ("the draft Regulations"). The 5 headings are:

1. Chapter 2 – Transfers of client assets. This chapter sets out a package of measures to enable administrators to carry out transfers of the business of an investment firm, and consequently of client assets, more quickly and easily
2. Chapter 3 – Bar dates. This chapter sets out proposals for extending and strengthening the SAR bar date mechanism
3. Chapter 4 – Interaction of SAR and CASS. This chapter sets out proposals for ensuring that the SAR regulations interact effectively with the FCA's client asset (CASS) rules, including ensuring clarity around clients' claims on the failed firm
4. Chapter 5 – Procedural and administrative proposals. This chapter sets out proposals for improving procedural and administrative process in the SAR in practice, including for an enhanced role for the Financial Services Compensation Scheme (FSCS). Other recommendations the review made in this area are explored in the FCA discussion paper published alongside this consultation document, and the FCA's consultation paper "Financial Services Compensation Scheme: changes to the Compensation sourcebook"[5]
5. Chapter 6 – Lessons learned. This chapter sets out lessons learned from the various Court cases that have arisen in respect of recent investment firm administration proceedings (both SAR and non-SAR) and how the government has reflected on these in developing its response to the review

1.8 A number of SAR administrations are currently in progress. The proposals set out in this document will not apply to a firm put into the SAR before the date on which they come into force (including where the SAR is used in conjunction with the Bank Insolvency Procedure or Bank Administration Procedure as under the Act). This will ensure certainty for those involved in

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[5] 'Financial Services Compensation Scheme: changes to the Compensation sourcebook', Financial Conduct Authority, November 2015

special administrations which are on-going when the law is changed. This means that these reforms will only apply to firms that enter the SAR on or after the day on which the reforms come into force. The transitional provisions required to achieve this are in regulation 15 of the draft Regulations.

2 Transfers of client assets

2.1 Currently, the SAR establishes a set of "special administration objectives", which the administrator is required to pursue. The administrator's first objective ("Objective 1") is to return client assets as soon as is reasonably practicable.[1] The administrator may meet this objective either by returning the assets directly to clients, or by transferring them from the failed firm to another institution. However, the SAR does not currently provide an explicit legal mechanism to facilitate these transfers.

2.2 The review identified improving the feasibility of completing transfers as a key priority for reform. The review recommended a "greater focus be given to facilitating transfers in the SAR" and sets out some "mechanical and practical" amendments to facilitate the successful completion of transfers in practice.[2]

2.3 Transfer may be preferable to returning client assets in some circumstances. For example, in certain situations, clients whose assets and contracts are successfully transferred to a new firm will be more likely to receive continuity of services for their assets and possibly faster access to their assets as these will not be part of protracted insolvency proceedings. This can reduce the market impact of firm failure. A transfer may also be beneficial for any remaining clients (whose assets are not transferred) as fewer will form part of the administration of the failed firm's estates, potentially speeding up the return of assets. Furthermore, a sale of the firm's business may enable the administrator to make better distributions to creditors.

2.4 The government agrees with the review recommendations to enable transfers to take place more easily, and this chapter sets out proposed technical changes to the SAR which will facilitate this. The government has also identified further minor and technical changes to support transfers, in addition to those set out in the review. These include changes to CASS to enable the transfer of client money, and clarifying the status of tax wrappers in a transfer. This chapter sets out in more detail how the government proposes to respond to each of the Bloxham recommendations in this area.

Bloxham recommendation 1 – transfer mechanism

2.5 The review recommended introducing a mechanism to facilitate rapid transfer of customer relationships and assets, where feasible.[3] The review highlighted a number of issues that would have to be addressed in any mechanism:

- the power to novate client contracts without client consent and to override any restrictions which might otherwise give a client the right to object to a transfer
- the power to override confidentiality or data protection obligations
- short moratorium on the termination rights of third parties
- the impact of transfers on set off and netting arrangements
- consideration of FCA regulatory requirements

[1] See Reg.10(1) of the Investment Bank Special Administration Regulations 2011.
[2] Review, page 37
[3] Review recommendation 1, page 37

2.6 The government supports the review's recommendation to introduce a mechanism to facilitate the transfer of relationships and assets. The proposed elements of the transfer mechanism, addressing the key considerations in paragraph 2.5, are:

- provisions for the novation of client contracts and assets by operation of law as part of a wider business transfer
- provision for a limited moratorium on the exercise of termination rights by custodians
- provisions to allow the sharing of confidential information

Novation of client contracts

2.7 Currently, an administrator is required to obtain consent from clients before completing a transfer. As the review notes, the FCA may waive regulatory requirements in this regard[4] but certain contractual terms may still restrict the transfer. Even where the firm itself had already procured consents within original investment contracts, the status of every investor agreement would still need to be ascertained by the administrator. Bloxham therefore recommends that administrators should have the power to "novate" client contracts (i.e. substitute an existing contract with a new contract) without client consent, for the purposes of carrying out a transfer. The government supports this recommendation, but not as a power for exercise by the administrator. Where the administrator judges that a transfer of business is the best way of delivering Objective 1, it will be important to ensure that this can happen quickly and easily – and enabling a transfer of client contracts and assets by operation of law (i.e. by provision in the SAR about business transfers) will support this objective. To facilitate transfers, the government therefore proposes to introduce:

1. novation of client contracts by operation of law, so that individual client consent is no longer required (but subject to the proposals set out in paragraphs 2.14 to 2.17)
2. provision to override other restrictions which might otherwise obstruct transfer (such as a prohibition against assignment)

2.8 Under statutory novation contracts of transferring clients will exist as if they had been made with the transferee firm, which will ensure the transferee firm is not in breach of certain FCA regulatory requirements. The proposal would also allow administrators to override various restrictions in order to complete a transfer. To ensure that the interests of clients and third parties are protected, the government is proposing two safeguards.

Safeguard for set off and netting arrangements

2.9 The first safeguard that the government is proposing concerns the protection of set off and netting arrangements. The government notes that enabling an administrator to negotiate transfer terms in the knowledge that whatever terms may be negotiated the SAR will operate to transfer client positions could in principle allow the administrator to agree transfer terms that interfere with set off and netting arrangements that clients may have with the failed firm (or with third parties). The government considers that it is important to protect these arrangements, as they are an important part of firms' risk management. The BRRD requires safeguards to protect set off and netting from interference when a deposit taker is resolved, and the government considers that the SAR should make equivalent provision for investment firms in the more limited case of a commercially agreed transfer of business supported by provision for the transfer of client positions by operation of law.

[4] Review, page 38

2.10 Therefore the government proposes to introduce specific protections for set off and netting arrangements, as set out in regulation 8 of the draft regulations (see new regulations 10D and 10E inserted in the SAR Regulations). The proposed measure ensure that partial property transfers provided for the transfer of all rights and liabilities under set-off arrangements, netting arrangements or title transfer financial collateral arrangements between the bank and a client or other person, so that assets and rights could not be separated from the liabilities with which they had been matched with for the purposes of set off or netting. The government has requested the Banking Liaison Panel (BLP) to consider in greater detail the issue of protecting set off and netting arrangements in the SAR, and any advice they provide to the Treasury will be published on the BLP's website. The government would welcome views on the proposed approach for protecting set off and netting arrangements as set out in the draft Regulations.

Safeguard for clients' access to their assets

2.11 The second safeguard concerns the protection of clients' access to their assets. As noted above, statutory novation involves the transfer of clients' contractual rights without their consent. The purpose of provision for novation by operation of law is to ensure a swift return of client assets in accordance with Objective 1 – and to this extent should be of benefit to the generality of clients and creditors. However, to ensure the that novation does not result in disproportionate interference with individual clients' property rights, the government proposes to introduce a safeguard to ensure clients may request their assets be returned by the transferee firm as soon as practically possible. This is implemented by regulation 8 of the draft regulations (see new regulation 10C(9) inserted in the SAR Regulations). In addition, as set out in the FCA's discussion paper published alongside this consultation, the FCA is considering a requirement to ensure that clients are notified in the event of a transfer, which will ensure that they can request return of their assets from the transferee firm immediately or as soon as they wish to do so.

Termination rights

2.12 The review recommended that the government consider providing for a short moratorium on the termination rights and other default rights of solvent third parties. This would prevent these counterparties from closing out, ensuring that certain contracts remain in force for the duration of the moratorium.

2.13 The Treasury has considered this proposal, and in particular carried out work to identify whether there are particular types of contracts where such a moratorium would be beneficial. The Treasury has concluded that the primary benefit of such a moratorium would be to provide for the continuation of custodian activities over the course of the administration. Therefore, rather than introduce a blanket moratorium, the government proposes to extend the scope of regulation 14 of the SAR Regulations (continuity of supply) to include custodian activities, as set out in regulation 13 of the draft Regulations. This would ensure custodians were not able to exercise their termination rights as a result of a firm's entry into the SAR, except under the circumstances set out in regulation 14(2) of the SAR Regulations. This proposal would assist the administrator to negotiate and successfully complete transfers as the provision of essential custodian services would continue in accordance with the relevant contract, providing certainty for a transferee firm.

Confidentiality

2.14 The review noted that data protection and confidentiality obligations may prevent transfers from taking place in practice. In past cases, administrators have been reluctant to share client data with transferee firms, in order to ensure they are compliant with confidentiality obligations.

2.15 The government recognises that the confidential nature of some information held by an investment firm may act as a barrier to the successful completion of transfers. For example, where a client has a contract with the failed firm requiring them to hold certain information in confidence, under the current arrangements it may not be possible to share this information with the transferee. This has in the past prevented the successful completion of transfers.

2.16 The government therefore proposes to make provision which permits the administrator to disclose information which is, in the administrator's view, relevant to the transfer of client assets or client contracts and overrides requirements to hold information in confidence, which might otherwise preclude the sharing of data with an institution which has entered into a binding agreement with the administrator for a transfer of the investment bank's business. This would allow the administrator to share information with a transferee firm more readily, but not incompatible with data protection law. This proposal would be implemented by regulation 8 of the draft Regulations (see new regulation 10C(7) and (8) inserted in the SAR Regulations). The transferee will continue to be under the same obligations to protect confidential information as those which were binding on the investment firm and the administrator under contract, common law, the Data Protection Act and other relevant legislation.

2.17 The government has considered whether the disclosure of the specified kind of information (subject to the same conditions) should be permitted in relation to sharing data with potential transferee firms, to inform and assist the process of a negotiating a transfer. The government would welcome views on the benefits of extending the power in such a way.

Consultation questions

1. Would the proposals as they are set out above and in the draft Regulations help to facilitate transfers?
2. What are your views on the safeguards for set off and netting, and for protection of clients' access to their assets, described in paragraphs 2.9 – 2.11?
3. What are your views on the proposals for termination rights set out in paragraph 2.12-2.13?
4. What are your views on the proposed approach to confidentiality set out in paragraphs 2.16 – 2.17?

Bloxham recommendation 2 – return / transfer objective

2.18 The review recommended the SAR regulations should be amended to make it clearer that an administrator has an option to transfer client assets to another investment firm instead of returning the assets directly to clients[5].

2.19 The government supports the review's analysis that the SAR Regulations could be amended to emphasise the return of client assets by way of transfer, and this chapter sets out new measures to ensure that a transfer can be done quickly and easily. However, the government notes that the Act explicitly defines "return" in relation to assets to include the "transfer" of assets, and that amending Objective 1 to include an express reference to transfer would have no legal effect. The government therefore does not intend to amend Objective 1 in the way the review recommends.

[5] Review recommendation 2, page 37

Bloxham recommendation 27 – co-operation involving HMRC

2.20 An important part of executing a successful transfer is ensuring that the tax privileges a client may have in respect of particular products is maintained following the transfer. The review recommended a duty be introduced for Her Majesty's Revenue & Customs (HMRC) to cooperate with administrators to ensure that ISAs and other investment products with tax advantages can be promptly transferred to other financial institutions rather than the money (or other assets) be returned to clients.

2.21 The government supports the intention of the recommendation. Current regulations already permit such transfers, subject to certain requirements. Where an ISA provider is no longer able to offer accounts, current ISA rules permit the transfer of ISA accounts in bulk (i.e. more than one account) to a new provider. This means that account holders will continue to benefit from ISA tax advantages on their savings and investments. Similar provisions apply under relevant SIPPs and other pension and life insurance regulations which enable such business lines to be transferred and the holders of these products to retain the tax status of their products.

2.22 The ISA rules require administrators to notify HMRC when transferring accounts to a new ISA manager.[6] This can be done by letter or email, but is generally done by phone. This enables HMRC to assist with any queries administrators may have, to ensure the tax status of the product is maintained intact.

Consultation question

5 What are your views on the remainder of the proposals in relation to Objective 1 and co-operation involving HMRC?

[6] Regulation 19 of ISA Regulations

3 Bar dates

3.1 The bar date mechanism currently established in the SAR gives administrators the power to set deadlines for clients to submit claims for the return of their assets.[1] This is intended to expedite the return of custody assets[2] (but not client money) in accordance with the administrator's first objective under the SAR, "to ensure the return of client assets as soon as reasonably practicable".

3.2 A bar date is a deadline for clients to submit claims and be eligible to participate in a particular distribution of custody assets. It gives certainty over the group of claimants for an upcoming distribution, ensuring that a distribution of custody assets by the administrator can progress smoothly without disruption from late claimants. In general, a late claimant may not challenge a distribution that was made after a bar date, provided the administrator carried it out in good faith.

3.3 The existing bar date process includes a number of procedural safeguards to protect clients' property rights. As the bar date mechanism ensures that a late claimant is not able to disrupt distributions made after a bar date has passed[3], and provides clients with good title to the assets they receive through the distribution[4], the mechanism could interfere with the property rights of an individual who has, for any reason, failed to make a claim to participate in the distribution. The safeguards include:

- requirements for publicising the cut-off date for claims and the time period given for clients to calculate and submit claims
- allowing clients (and the Prudential Regulation Authority (PRA) or FCA) to seek an extension of the deadline
- requiring administrators to contact clients who have claims according to the firm's records but have not come forward
- requiring court approval for distributions made during the bar date period

3.4 The review supported the existing bar date mechanism as a positive tool for improving the speed of distributing custody assets, which has been valuable in some SAR cases to date. However, the review also identified potential reforms to the bar date mechanism, including:

- extending the bar date mechanism to include client money
- aligning the treatment of the client money and custody asset claims processes
- providing administrators with increased flexibility when making distributions
- strengthening the mechanism to provide for a hard bar date

3.5 The government proposes to implement the review's recommendations for improving the bar date mechanism in full, and to include appropriate safeguards. These proposals would provide increased certainty for the administration process by bringing closer together the custody asset and client money claims processes; and speed up both distributions of client assets

[1] Regulation 11 of the Investment Bank Special Administration Regulations 2011

[2] Review, page 11

[3] Regulation 5(a) of the Investment Bank Special Administration Regulations 2011

[4] Regulation 5(b) of the Investment Bank Special Administration Regulations 2011

to beneficial owners and the handling of unclaimed and surplus client assets. Taken together these measures would help expedite the administration process and reduce overall costs.

Bloxham recommendation 4 – extend bar date to client money

3.6 Bloxham noted that at the time the SAR was introduced, a number of client money cases were progressing through the courts following the failure of Lehman Brothers International Europe (LBIE).[5] The likely outcome of the cases was not clear, and it was possible they would have an impact on the application of client money rules in insolvencies. For this reason, client money was not included in the bar date mechanism when the SAR was first implemented.

3.7 However, since the SAR was introduced some administrators have found it necessary to set bar dates for client money, and have had to go to court to receive permission to do this. The need to go to court to seek permission to set client money bar dates has led to increased costs and uncertainty within the administration process. The review therefore recommended the bar date mechanism be extended to include client money.

3.8 The government supports the Review's recommendation and regulation 12 of the draft Regulations (see new regulation 12A inserted in the SAR Regulations) sets out the proposal for extending the existing bar date mechanism for custody assets to client money. The bar date mechanism for client money would be similar in effect to that for custody assets and, in addition, the government proposes to provide for a hard bar date mechanism for custody assets and client money, which is considered in more detail in 3.24-3.26 below.

3.9 The proposal would give administrators the power to set a bar date for the submission of claims for client money. Following the bar date, the administrator would have to make a distribution of client money according to the clients' entitlements established under the claims received. Similar to the bar date for custody assets, late claimants would lose the right to challenge a distribution made to meet claims made before the bar date. This allows the administrator to make any necessary distributions and proceed with the administration process, as they would not be required to give regard to the entitlements of clients who had failed to submit claims in good time. However, a late claimant provision, similar in effect to that for the bar date for custody assets, has been included to protect clients' interests. Under this provision, the administrator would have to make a distribution to late claimants if there is still money available in the client money pool to do so.

3.10 The proposal would not require administrators to set a bar date for client money, but rather, gives them the power to set one where they think that it is necessary to do so to expedite the return of client money in accordance with Objective 1 of the SAR. A bar date may not be appropriate where an administrator is able to establish client entitlements using the firm's own records alone, without the need for a claims process. Apart from this process, the government notes that a claimant may choose not to submit a claim for payment from the client money pool, because they intend to pursue a claim as an unsecured creditor (see paragraph 4.13).

[5] Review, page 39

Consultation question

6 Do you agree with extending the bar date mechanism to client money using this method?

Bloxham recommendation 5 – align treatment of client money and custody asset claims

3.11 The review recommended the government consider whether treatment of client money claims on the failed firm's estate could be more closely aligned with the treatment of claims for the return of custody assets.[6] The proposals described in paragraphs 3.6 to 3.10 to introduce a bar date mechanism for client money will mean that the treatment of client money claims will be more closely aligned to that for custody assets. As set out in chapter 7, the government has reviewed recent case law to identify lessons learned for the improvement of the SAR. The government has not identified any further areas where it would be beneficial to align treatment of client money and custody asset claims.

Bloxham recommendation 6 – permitted distributions

3.12 The Review recommended removing restrictions to allow administrators to distribute client assets (other than client money) outside a claims procedure even after the announcement of a bar date.[7] The government has also considered what additional flexibilities could be introduced in this area to further speed up the distribution of client assets.

3.13 Currently, setting a bar date triggers the need for a distribution plan, and the SAR then only permits distributions in accordance with the approved plan[8]. In addition, no custody assets may be distributed earlier than 3 months after the bar date[9]. If the administrator wishes to distribute before the 3 month period has elapsed, or not in accordance with the plan, they will need court approval.

3.14 However, if the administrator has not set a bar date, they do not need a distribution plan or court approval to make distributions. Prior to commencing the bar date procedure an administrator is likely to distribute custody assets only to clients whose beneficial entitlement cannot be disputed. This is because, without the protections of the bar date and a court-approved distribution plan, the administrator risks leaving themselves and the recipient of any returned custody assets open to challenge by a later claimant to those same assets.

3.15 The government supports the recommendation to increase the flexibility administrators have when distributing custody assets under the bar date mechanism. Experience suggests the restrictions are unnecessarily restrictive in practice,[10] and removing them will help facilitate the speedy return of custody assets. The proposed approach to implementing the recommendation is set out in regulation 10 of the draft Regulations (see amendments to regulation 11 of the SAR Regulations).

3.16 Under the proposal, administrators would be able to continue returning custody assets after having set a bar date up until they submit a distribution plan to the court for approval. This removes the restriction that prevents administrators returning client assets outside a distribution

[6] Review recommendation 5, page 40
[7] Review recommendation 6, page 40
[8] Reg. 11 of the Investment Bank Special Administration Regulations 2011
[9] Rule 144(3) of the Investment Bank Special Administration Rules (England and Wales) 2011
[10] Review, page 40

plan after a bar date process has been commenced, and would allow administrators to return assets promptly where they are certain of the beneficial ownership of those assets.

3.17 The government also proposes to replace the requirement for 3 months to elapse after the bar date before an administrator may distribute custody assets with a requirement for a "reasonable" amount of time to elapse before they may start distributing assets. This would need to be implemented by amending the SAR insolvency rules, as discussed in paragraph 5.21. The administrator would still be required to notify clients who had not submitted a claim by the bar date deadline, where the administrator was aware of their entitlement according to the firm's records, and to allow 14 business days for claimants' responses to be received.[11]

3.18 As noted in 3.13 above, any distribution of custody assets made after the distribution plan has been presented to the court for approval must be made in accordance with the distribution plan. Therefore, the distribution plan needs to represent the whole picture for the court to be able to consider it properly, including both the assets available for distribution and those assets already distributed and to whom. The SAR insolvency rules do not currently require an administrator to include in the plan any assets the administrator has distributed prior to submitting the plan. The government proposes to require administrators to include such assets in the distribution plan but the administrator would be able to submit for court approval any justification for omitting from the distribution plan any assets held in confidence by the investment firm. This proposal would need to be implemented by amending the SAR insolvency rules.

Consultation question

7 Would the SAR benefit from providing administrators with flexibilities when distributing assets additional to those identified here?

Bloxham recommendation 7 – hard bar date

3.19 The existing bar date mechanism in the SAR and the mechanism proposed for client money as set out above are known as soft" bar dates[12] because late claimants lose the right to challenge any distributions made before they claim, but they still have the right to receive client assets from later distributions, should there be any. By contrast, a "hard" bar date would remove a client's right to claim on the client estate.

3.20 The review recommended that the SAR be strengthened to allow for a hard bar date following the use of a soft bar date. In previous SAR administrations administrators have been left with a residue of client assets that they have been unable to return; and in the case of custody assets a residue remained even after following the bar date procedure as currently set out in the SAR. This prevented administrators from closing the client estate, leading to increased administration costs as the process became increasingly protracted. A hard bar date would allow administrators to transfer residual assets (or the proceeds of their disposal) to the bank's general estate and close the client estate earlier than would otherwise have been feasible. This would lead to a faster administration process and lower total costs.

3.21 The government supports this recommendation, and the proposals to introduce hard bar dates, along with safeguards to protect the interests of clients, are set out in draft Regulations 12B and 12C. The government recognises that bar dates are not used in all SAR administrations, as administrators are able to distribute client assets outside of the bar date mechanism. The hard

[11] Rule 143 of the Investment Bank Special Administration Rules (England and Wales) 2011

[12] Review, page 40

bar date is a backstop power available to administrators to be used as required in order to facilitate the return client assets in accordance with Objective 1 of the SAR. An administrator has a discretionary power to set bar dates under specified circumstances, and a failure or refusal to set a bar date could be the subject of a challenge brought before the courts by clients or creditors.

3.22 The hard bar date provisions for client money and custody assets are broadly similar, but are drafted to take account of the different nature of client money and custody assets, and they are considered in more detail below. The bar date for custody assets is considered in paragraphs 3.24-3.26 and the bar date for client money is considered in paragraphs 3.27-3.29.

3.23 Given the proposals to introduce hard bar dates may have consequences for the rights of clients, the government has considered the relevant issues and is satisfied that the proposals are compatible with the European Convention on Human Rights. The legislation proposed to implement the measures includes procedural safeguards that would ensure the volume of affected clients is minimised. In particular, administrators would be required to set a soft bar date before setting a hard bar date. Further, as set out below, in order to satisfy the court and be able to set a hard bar date, the process must have reached a point that the administrator cannot reasonably be expected to do anything further to return client assets. Further, the number of clients represented in the rump of client assets in previous SAR administrations has been small and the value of their assets, as a percentage of the entire client pool, was also small. The government's view is that these measures are in the public interest, and strike a fair balance between the interest of those affected and the public interest in securing a swifter and more effective distribution of client assets.

3.24 The custody asset hard bar date as set out in draft Regulation 12B would enable an administrator to sell any custody assets that remain in the client estate after a final distribution, and pay proceeds from the sale into the failed firm's estate.

3.25 Under this proposal, an administrator would be able to seek approval for the option to use a hard bar date as part of the distribution plan and would then have to seek court approval to set the hard bar date. Including the option to set a hard bar date in the distribution plan would provide clients and creditors with an opportunity to challenge or object to the proposed use of a hard bar date. The additional requirement to obtain court approval when the administrator comes to set a hard bar date provides independent scrutiny that the process has reached the point where the administrator cannot reasonably be expected to do anything further to return client assets. This would include the administrator taking adequate steps to contact clients shown in the failed firm's records who have not submitted a claim, or taking sufficient action to identify clients where the firm's records are poor.

3.26 Clients who claim after the hard bar date has passed but before residual custody assets have been sold (or arrangements for their sale been made), would be entitled to a return of assets out of the residue. Clients who submit a claim after the residue has been sold and the proceeds have been transferred to the general estate would be able to make a claim for the recovery of an unsecured debt against the failed firm's estate, and any such claims would be valued according to the proceeds from the sale of relevant custody assets[13].

3.27 The client money hard bar date as out in regulation 12 of the draft Regulations (see new regulation 12C of the SAR Regulations) would allow an administrator to treat the client money pool as closed and transfer any money remaining in the pool to the general estate.

[13] This method for valuing claims differs from the valuation method for "shortfall claims" (see Reg. 11 of the SAR Regulations). The government considered the merits of having the same valuation methods for both cases but has concluded it is reasonable and appropriate to have different methods, recognising the different natures of the claims.

3.28 Under this proposal, administrators would be given the option to set a hard bar date, where a hard bar date would be the final deadline for the submission of clients' claims for the return of client money from the client money pool. After the hard bar date had passed, the client money pool would be closed and the administrator would be not be able to accept any more claims from clients to the client money pool. Any residue remaining in the client money pool after the administrator had made the final distribution would be transferred to the firm estate. Clients who submitted a claim after the bar date would be able to make a claim for the recovery of an unsecured debt against the failed firm's estate.

3.29 Similar to the bar date procedure for custody assets, the government has included safeguards to protect the interests of clients, and these are set out in paragraph 3.23 above. The government does not propose to include client money in the distribution plan process.

Consultation questions

8 Do you agree with proposed approach for introducing a hard bar date as set out above?

9 Do you think additional protections for clients are required?

4 Interaction of SAR and CASS

4.1 As set out in the introduction to this document, the SAR Regulations sit within a wider insolvency framework which includes the SAR insolvency rules, FCA rules, and general insolvency law. The review made a wide set of recommendations intended to ensure that the SAR and FCA rules work well together. The government agrees with the review's objective in this area. The proposals set out in this chapter, taken together with the amendments to rules set out in the FCA's discussion paper, are designed to ensure consistency across the SAR framework.

4.2 The SAR is closely modelled on provisions for the administration of companies under the Insolvency Act 1986 ("the 1986 Act"), but with special features designed to ensure that administrators are able to address the specific challenges that arise from an investment firm failure. Most importantly, the SAR ensures that the administrator returns client assets as soon as reasonably practicable. In this regard, the SAR interacts with CASS – the set of requirements that firms comply with when holding client assets. The CASS rules require firms to properly segregate client assets from the firm's own assets, which ensures that if a firm fails, clients' assets can be identified and swiftly returned to clients.

4.3 The review made specific recommendations for changes to the way the SAR and the CASS rules interact, to further reduce market uncertainty, minimise the impact of investment firm failure, and reduce the time taken to complete administrations. The review also recommended that the authorities should review the interaction of CASS and SAR more widely, to identify potential conflicts that could be addressed through changes to either regime. In particular, the review recommended that:

- there should be clarity as to where CASS, the SAR or other general insolvency law applies to determine client entitlements
- there should be no unnecessary gaps or conflicts between CASS and the SAR
- there should be guidance as to the allocation of administration costs between the estates
- the administrator should have the power to move client money from any firm accounts it may be held in at the point of failure to client accounts

4.4 This chapter sets out the government's response to those recommendations.

Bloxham recommendation 8 – client assets: consistency

4.5 The review recommended that the SAR and CASS should be amended to ensure that they provide clarity on clients' rights to interest, income and distributions in respect of client assets.[1]

4.6 Currently, clients are not entitled to receive interest on their client money claims for the period of the administration – if there is any surplus in the client money pool after meeting client entitlements it becomes part of the general estate. In contrast, where there is a surplus after payment to creditors of debts proved against the general estate, creditors making claims

[1] Review recommendation 8, page 42

against the general estate are entitled to statutory interest from the date of entry into administration until the date of the payment of the debt.

4.7 The review noted that, due to this difference in treatment, in previous administrations of investment firms (both those carried out under the SAR, and those carried out under the 1986 Act, prior to introduction of the SAR), some clients have delayed submission of their claims, so they could claim from the estate (client or general) from which they would be likely to receive the largest pay out, which taking statutory interest into account, may be from the general estate. This was not how the regime was intended to function, and the arbitrage has led to delays in previous administrations, resulting in increased administration costs.

4.8 In assessing how to respond to the recommendation, the government has sought to weigh the interests of clients against those of creditors. On balance, the government's view is that there is a compelling public interest in preventing arbitrage by clients that results in detriment to the generality of clients and creditors.

4.9 The government therefore accepts the review's recommendation, and regulation 9 of the draft Regulations (see new regulation 10G of the SAR Regulations) implements the proposal to clarify clients' rights to interest. Under the proposal, a client would not be entitled to receive interest on a contractual claim (see paragraph 4.13) on the firm's estate so far as the amount of that unsecured claim does not exceed the amount which they could have received on a distribution of client money from the client money pool. Removing this entitlement to receive interest is designed to remove the incentive to engage in arbitrage and should help to ensure that clients bring claims against the client estate. Clients would still be entitled to receive interest on any shortfall claim against the firm's estate, as shortfalls in client assets can arise through no fault of the client. As such, the government's view is that it would be not be proportionate to remove the entitlement to receive interest on shortfall claims.

Consultation question

10 What are your views on the proposal that clients should not be entitled to receive interest on unsecured claims on the general estate?

Bloxham recommendation 9 – clarify Objective 1

4.10 Under the SAR, the administrators' first objective is to ensure the speedy return of assets to clients as soon as practicable. The review notes that in past SAR administrations, it has not always been completely clear whether clients' entitlement to a distribution of client assets derives from CASS, the provisions of the SAR itself, or from general insolvency law. The review therefore recommended that Objective 1 should be amended to provide that the administrator's role is to apply the applicable distribution regime in CASS.

4.11 The government agrees that in SAR cases, it is appropriate that CASS rules should regulate the distribution of client money from the client money pool. This is already the position, as established by case law in relation to LBIE and MF Global. In reviewing the SAR, the government has identified certain areas where express reference to the FCA rules is necessary to provide clarity about how the SAR and CASS rules interact, for example the provisions establishing a 'bar date' for client money claims.[2] However, the government's view is that it is not necessary to make express provision in Objective 1 that CASS rules safeguard client money and govern the distribution of the client money pool, as this is already clear as a matter of law.

[2] The bar date proposals are set out in Chapter 3 of this document, and draft Regulations 12A and 12C

Consultation questions

11 What are your views on the government's proposal not to amend Objective 1, as set out in paragraph 4.11?

Client claims arising from client money entitlements

4.12 The review made a series of recommendations to the effect that the government should review and expand the SAR provisions associated with a client's claims on the failed firm arising out of client money entitlements.

4.13 As the review sets out, cases in the administration of MF Global established that clients of a failed firm will have dual status in respect of client money claims they are able to make. These claims are valued using different methodologies, and this causes anomalies in an administration.

- first, clients have a claim on a share of the client money pool as a result of the statutory trust established under CASS, together with an unsecured claim on the general estate for any breach of trust which results in a shortfall in distributions from the client money pool. At the point of failure the amount of client money due to a client will be given a notional valuation where there are open positions (i.e. the value of the asset on the date of the pooling event)
- second, clients will have a parallel (or contractual) claim under contract on the general estate. The claim under contract (the "contractual" claim) is based on the value at which the contract is closed out at the date at which it is closed out, and this is known as the "hindsight" principle

4.14 The review notes that the different claims a client is able to make, and the different valuation methodologies for the claims present two challenges. First, the types of client money claims a client is able to make are not set out in the SAR or CASS, and the treatment and claims process for client money and custody assets are not aligned. Second, a different valuation method date places a considerable burden on the administrator, which complicates and delays the administration process.[3]

Clarifying claims on the firm estate

4.15 In order to address the problems identified in paragraph 4.14, the review recommends that:

- the authorities should consider extending the "hindsight" principle to the valuation of clients' claims on the client money pool. Currently, the hindsight principle only applies to contractual claims. The review argued that a wider application of the hindsight principle is more likely to ensure that client claims will more closely correspond with the actual value of assets in the client money pool[4]
- the Treasury should ensure the relationship between a 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[5]

[3] Review, page 17-18

[4] Review recommendation 14, page 41

[5] Review, recommendation 10, page 41

- the SAR should set out the basis on which clients who do not recover all of their monies from the client money pool are entitled to make claims against the failed firm's estate (known as "shortfall claims")[6]

4.16 In relation to the first of these, the government agrees that adopting the hindsight principle could help address the problems that arise as a result of the basis of calculation for shortfall claims and the need for clients to make multiple claims in an insolvency. The most appropriate legal vehicle for implementing a hindsight principle is in the CASS rules. As set out in the FCA's discussion paper accompanying this consultation document, the FCA is considering adopting the hindsight principle for valuing client's claims under client money distribution rules (CASS 7A).

4.17 In relation to the other two review recommendations set out in paragraph 4.15, the government notes that case law has referred to the types of claims a client is able to make in respect of their client money entitlement. In particular, the government notes that CASS gives rise to the trust claims a client is able to make, while a client's contractual claim is based on general legal principles and on the SAR. Claims for the recovery of shortfalls and contractual claims were considered in the MF Global case (considered in chapter 6), and the government believes it is for the courts to decide what claims a client is able to make under different circumstances. Codifying the types of claims clients are able to make could have unintended consequences because it would trespass on matters which are properly governed by general principles of law and the application of insolvency legislation. Considering this, the government considers that the case law to date has provided a considerable degree of clarity in relation to the types of claims that clients are able to make for the return of client assets, and does not propose to codify the legal position.

Harmonising client money and custody asset claims

4.18 In addition, the review recommends that the treatment of client money and custody assets should be harmonised, unless there is a good reason not to.[7] As set out in chapter 3, the government proposes to align treatment by extending the bar date mechanism to client money[8] and to align the client money and custody asset claims processes.[9] The government has reviewed the existing treatment of custody assets, client money, and unsecured creditor claims in an administration, and did not find any areas in need of alignment additional to those addressed in this document.

Consultation question

12 What are your views on the government's approach to clarifying and harmonising claims a set out in paragraphs 4.16 – 4.18?

Bloxham recommendations 12 and 45 – guidance to be provided on the allocation of administration costs

4.19 The review recommended the government provide guidance on how costs borne by the firm's estates should be apportioned. In particular, the review acknowledges that maintaining a distinction between costs attributable to dealing with client assets and those attributable to

[6] Review, recommendation 11, page 41
[7] Review recommendation 13, page 41
[8] Review recommendation 4, page 39
[9] Review recommendation 5, page 39

dealing with assets belonging to the firm's estate can be difficult, and recommends that further guidance should be provided in the SAR regarding such costs[10].

4.20 The review also recommended that the government should empower the Courts to direct that costs arising as a result of the firm's failure to comply with regulatory obligations should be borne by the firm's estate. Some client asset costs in an administration may be directly attributable to the firm not complying with regulatory obligations, e.g. where the firm has not segregated assets or has poor record keeping. Where the failed firm's records are inadequate, a significant proportion of the administration costs arise from work to re-construct or bring records up to date. The review recommended these costs be allocated to the firm's estate[11].

4.21 The government agrees that it would be useful to set out guidance for the allocation of costs between estates. The government also agrees that costs arising from compliance failures should be borne by the estate. Currently, clients are charged fees which include costs of client asset protection and therefore allocating costs arising as result of a firm's non-compliance with client asset protection requirements results in these clients suffering additional expenses. Considering this, the government does not consider it is appropriate that costs are allocated to clients rather than creditors in this way. However, rather than make this subject to the direction of the Court, the government proposes simply to use the SAR Regulations to set out how such costs should be allocated.

4.22 Draft Regulation 8 therefore provides that the administrator may assign to the estate of the failed firm those costs that have been incurred as a result of the firm not complying with CASS rules; such as those that require segregation of client assets and maintenance of adequate records. In order to allocate costs in this way the administrator would have to obtain the agreement of the creditor committee or, where there is no such committee (or where agreement cannot be reached), the administrator may seek guidance on the allocation of costs from the Court.

4.23 The proposal does not require an administrator to allocate costs in this way. This is to ensure there is flexibility in the SAR for where there are insufficient funds in the firm's estate to conduct the administration. In these circumstances it is likely to be in the clients' best interests for certain expenses attributable to winding up the firm estate to be met from the client estate, to ensure that there is a timely winding up of both estates.

Consultation questions

13 Do you think administrators should have to seek creditor committee, or court, approval for allocating costs in the way, or should they have a simple power to do so?

14 What are your views on the proposed approach for the allocation of costs in a SAR administration?

Bloxham recommendation 46 – final reconciliation

4.24 As discussed above, CASS requires firms to hold client money in segregated client accounts, so that it is available for distribution when a firm enters the SAR. The review recommended that where there is a shortfall in the segregated account, and where a firm uses the "alternative approach" (set out in more detail below), administrators should be given the

[10] Review recommendation 12, page 24
[11] Review recommendation 45, page 24

power to "top up" the client money pool with client money held in the firm's own account. The review also recommended that the government consider extending this measure beyond just the alternative approach[12].

4.25 The "alternative approach" refers to the way in which firms receive client money and reconcile their client money accounts. Under the "normal approach", a firm will receive all client money directly into segregated client accounts. However, some firms operate an "alternative approach", under which they receive client money into the firm's own account, and conduct a daily client money calculation to ensure the correct amount of client money is segregated.

4.26 Under the alternative approach, if a firm fails before the daily reconciliation has taken place there is a high likelihood that there will be a shortfall in the client account. The Lehman judgments went some way to closing this, as they established that identifiable client money should be pooled, even if it is held in unsegregated firm accounts. However, administrators currently lack the power to move client money into segregated accounts, making it more difficult to return the money to those entitled to it. The government therefore agrees with the review recommendation that where a firm is operating the alternative approach, the administrator should have a limited duty to transfer money from the firm account to the segregated client pool which, had the firm continued trading, it would have segregated the following day (and, if necessary, to move money from a segregated account to the firm account).

4.27 Even where a firm is operating the normal approach, circumstances can arise where there is a shortfall in segregated client accounts – such as where client money has been received into the wrong place, or where money has been assumed to have been received. In these circumstances, the firm must top up the client account with money from its own account following the daily reconciliation. Given that a shortfall can arise even under the normal approach, the government proposes that the limited duty imposed on the administrator to transfer amounts between client accounts and the firm's own accounts should apply whether the alternative approach or the normal approach has been adopted by the firm.

4.28 The duty to make such transfers would only extend to a final reconciliation carried out by the administrator to rectify a discrepancy that would have been rectified by the firm, according to its own records, had it not entered the SAR. The reconciliation itself would be done in accordance with the firm's own method for carrying out client money reconciliations, rather than a wholesale and complete reconciliation which would correct any past mistakes which may have been made by the firm. The government considered requiring administrators to carry out complete reconciliations, but concluded that the time this would take and cost it would incur, not least where firms have been established for many years, would significantly increase administration costs and hinder the progression of the administration, which is contrary to the aim of the proposals. Moreover, a complete reconciliation could lead to large amounts being transferred between the estates, possibly to their total or partial depletion and the government does not consider this a proportionate response to the problem as identified in the review.

4.29 Regulation 9 of the draft Regulations (see new regulation 10F of the SAR Regulations) implements this proposal.

[12] Review recommendation 46, page 31

Consultation questions

15 Do you think administrators should be required complete reconciliations before transferring amounts between client accounts and the firm's own accounts?

16 Do you think the proposals set out in this chapter are suitable in terms of aligning the SAR and CASS?

5 Procedural and administrative proposals

5.1 The review made recommendations for improving the functioning of the SAR in practice. These recommendations seek to address a number of issues that have led to uncertainty in past SAR administrations or created unnecessary delays and inconveniences.

5.2 The recommendations in this area included:

- ensuring entities that had dealings with the failed firm prior to its collapse cooperate with the administrator
- aligning the SAR with European regulations, such as European Market Infrastructure Regulation (EMIR)
- reviewing the law under which client asset entitlements arise, general insolvency rules, and the role of the courts in investment firm insolvencies;
- administrative and procedural issues
- the role of the authorities in SAR administrations

5.3 The government proposes to implement the majority of these recommendations as they would support the objectives for the SAR as set out in the Act and contained in the SAR Regulations themselves. This chapter considers the implementation of the recommendations.

Co-operation duties

Bloxham recommendations 21, 23, 24, 25 – duties of cooperation on parties involved in the insolvency

5.4 The review recommended duties be introduced for certain entities that had dealings with the firm prior to its failure to cooperate with the administrator. As set out in chapter 6, it is clear from previous SAR and non-SAR administrations that the administrator may not be able to reconcile final client positions using the failed firm's records alone.[1] The entities include:

- banks and other firms with client accounts where client assets and client money are held[2]
- counterparties of the failed firm[3]

5.5 The review also recommended a duty be introduced for administrators to cooperate with the FSCS, which would bring the SAR into alignment with the regimes for banking and insurance failures.[4]

5.6 The government supports these recommendations. Regulation 7 of the draft Regulations (see new regulations 10A and 10B of the SAR Regulations) lays down duties on banks and

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[1] Review, page 46

[2] Review recommendations 23 and 24, page 45

[3] Review recommendation 25, page 45

[4] Section 99(2) Banking Act 2012, and the Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010 (SI 2010 No. 3023)

custodians with client accounts holding client assets, on counterparties of the firm to work with the administrator, and on the administrator to cooperate with the FSCS.

5.7 Banks would be required to work with the administrator to facilitate the prompt return of client money, in accordance with Objective 1 of the SAR, to provide certain information when requested, and to assist the administrator with a reconciliation of the relevant records to determine what assets and money belong to which clients. Custodians would be under a similar duty with respect to custody assets. The government's view is that these proposals would not place new requirements on these entities and banks to collect information in addition to what is required under existing regulatory obligations, but would welcome views on this position.

5.8 Similarly, counterparties would be required to provide the administrator with information relevant to the purposes of the administration when requested. The counterparty would be able to produce evidence to suggest that the cost of complying with an administrator's request would be disproportionate to the benefit it would otherwise produce, should the request prove significantly burdensome.

5.9 The duty on the administrator would be to cooperate with the FSCS would ensure the administrator assists the FSCS carry out its functions, in particular to pay compensation when due, in relation to the insolvency of the failed firm. It would also enable the administrator to meet the requirements of Objective 1 (to return assets as soon as possible) where this is done by either returning assets to clients or transferring them to a new firm.

Bloxham recommendation 26 – cooperation to facilitate incomplete trades

5.10 The review notes that at the point of failure, a firm will be in varying stages of progress for a number of transactions. When the firm fails many of these trades will lapse but others may still be operative and yet to complete. The review recommends that cooperation arrangements in the SAR are extended "to give effect to pre-failure client instructions".[5]

5.11 The government recognises the recommendation is to require administrators and others to explore the feasibility of completing such trades, rather than actually complete them. Administrators already have the power to complete trades under the 1986 Act.

5.12 The BLP has raised two issues regarding the implementation of this recommendation. First, it requires administrators to take risks with client money, which is not what they are appointed to do. Second, it will introduce uncertainty into the market as investment managers will not know whether their clients' trades at the failed firm will complete or not. Currently, investment managers assume administrators will not complete these trades and recalibrate their clients' portfolios based on this assumption. A duty to explore the feasibility of completing incomplete trades will introduce uncertainty into the current arrangement, as investment managers will not know, possibly for some time, whether the administrator will complete a trade. Investors may then become over exposed to certain classes of investments as managers take measures to manage risk. This may expose investors to a greater or lesser degree of risk than their risk appetite allows for, or mean they break certain regulatory requirements. Therefore, the government does not propose to implement this recommendation.

Bloxham recommendations 22, 34, 61 – administrator cooperation with market infrastructure bodies

5.13 The review made three recommendations to improve the interaction between administrators and market infrastructure bodies, with the aims of reducing risk following the

[5] Review, page 47

failure of an investment firm, and of accelerating the return of client assets. The three recommendations are:

- a reciprocal duty be introduced for the administrator and market infrastructure bodies to assist in reconciling positions of the failed firm[6]
- the administrator to have the power to unilaterally close out open positions on derivatives[7]
- the guidance protocol[8] between central counterparties (CCPs) and insolvency practitioners to be updated with comments from FCA and professional and trade bodies[9]

5.14 The government does not propose to introduce a duty on market infrastructure bodies to cooperate with administrators, or to empower administrators to unilaterally close out open positions. However, the government supports work currently being done to update the guidance protocol between CCPs and insolvency practitioners.

5.15 When a clearing member of a CCP fails, the CCP will take default management action in respect of the defaulting member's positions in accordance with its default rules and arrangements. Giving the administrator the power to close out open positions unilaterally and requiring the CCP to cooperate with administrators will introduce uncertainty into this default management process. Notably, CCP default management procedures take precedence over normal UK insolvency law to reflect the key role CCPs have in the financial system.[10]

5.16 Early consultation with practitioners indicates administrators would find receiving information from CCPs early in the administration helpful for calculating final client positions and performing reconciliations. The government is aware CCPs and insolvency practitioners have considered information sharing as part of ongoing work on updating the guidance protocol.

Consultation questions

17 What are your views on the government's proposed approach to the review recommendations concerning cooperation?

Bloxham recommendations 37, 60 – SAR compatibility with European regulations

5.17 The review recommended the government consider how EMIR and the SAR will interact in a firm failure and make any necessary amendments to remove potential uncertainties and to recognise the lawfulness of non-EMIR porting.

5.18 Under EMIR, CCPs are required to attempt to "port" clients' positions (including margin) to another market participant in the event of firm failure[11] and the review noted that this could introduce uncertainties into the functioning of the SAR.[12] The government supports the review's recommendation to consider how EMIR and the SAR will interact. The government notes that

[6] Review recommendation 22, page 45
[7] Review recommendation 34, page 50
[8] *Cooperation Guidance between Recognised Bodies and Insolvency Practitioners To Assist Management Of Member Defaults by Recognised Bodies*
[9] Review recommendation 61, page 60
[10] See section 159 of the Companies Act 1989
[11] See EMIR Article 48(5 and 6)
[12] Review recommendation 37, page 52

the FCA has already made changes to facilitate the transfer of client money in accordance with EMIR, and the FCA's discussion paper published alongside this consultation document considers proposals to expand the ability to transfer client money. The government is not aware of any other areas where EMIR is not in accordance with the SAR or CASS.

5.19 In addition to porting in accordance with EMIR, if a counterpart fails, CCPs may unilaterally close out and substitute client positions without the administrator's consent outside of EMIR. The review recommended recognising the lawfulness of these transactions in the SAR.[13] The government has considered implementing this recommendation, but the legal effect of doing so remains unclear. The government would welcome views on the benefit of expressly recognising the lawfulness of these transactions in the SAR.

Consultation question

18 Do you have views on other changes that could be made to align the SAR with EMIR?

Bloxham recommendations 35, 41, 43, 54 – review of the insolvency rules, laws under which client asset entitlements arise, and the role of the courts in investment firm insolvency

5.20 As set out in chapter 4 the SAR operates in a wider insolvency framework. In addition to CASS, this includes general insolvency rules, the laws under which client entitlements arise in the UK client asset protection regime, and the court system. The review made a number of recommendations for these parts of the wider insolvency framework to improve the functioning of the SAR in practice.

5.21 The review recommended a review of the SAR rules be carried out to consider what aspects of current general insolvency rules and any future modifications could be included in the SAR rules.[14] The government supports this recommendation, and changes will be made to the SAR Rules as part of a wider insolvency rules reform programme.

5.22 CASS and the SAR may be supplemented in some cases by applying general rules of English property and trust law or equitable principles and, because this can lead to a complex and time consuming process for determining client entitlements, the review recommended the government consider the merits of a standalone mechanism for determining client asset entitlements. The government does not propose to introduce such a mechanism, as the benefits of overhauling the law in this manner are not proportionate to the disruption and legal uncertainty it would cause.

5.23 The review notes that in past SAR and non-SAR administrations the courts had a significant role in deciding issues, and the resultant delays and costs depleted the relevant pools of client assets. To improve the functioning of the SAR in practice, the review recommended[15] the government implement the recommendations Lord Justice Briggs set out in his 2012 Denning Lecture[16] and consider alternative methods of speeding up determinations of legal issues that will arise in investment firm insolvencies.[17]

[13] Review recommendation 60, page 60

[14] Review recommendation, page 51

[15] Review recommendation 41, page 54

[16] *The Denning Lecture 2012, http://www.bacfi.org/files/Denning%20Lecture%202012.pdf*

[17] Review recommendation 43, pages 55

5.24 The government supports these recommendations, and since the SAR came into force in 2011 the courts have introduced the Financial List initiative. The Financial List includes cases of very high value or concerned with matters of market importance, or both, and parties are able to commence proceedings in either the Commercial Court or the Chancery Division where cases will be dealt with by one docketed judge. A review of the initiative will include considering whether the provision enabling a leapfrog of certain cases to the Supreme Court directly from the High Court ought to be used more frequently, given the high profile nature of the cases likely to be in the Financial List.

Bloxham recommendations 28, 29 – administrator liability

5.25 The review confirmed that broad administrator liability should be retained in the SAR,[18] but recommended that limited protection from liability be provided for administrators in two specific areas. First, administrators should be able to make small value or hardship distributions to clients where clients have agreed to surrender the right to complete accuracy.[19] Second, administrators should be protected from "unfair prejudice" claims from unsecured creditors if they have kept on staff to retain corporate memory.[20]

5.26 The government does not propose to adopt these recommendations. Early consultation with administrators suggests that immunity from liability when making small or hardship distributions would not have a material impact on their behaviour. Further, although there are no cases that directly relate to whether excessive staff retention could constitute an unfair prejudice claim, case law demonstrates a repeated refusal by the courts to interfere[21] with the decisions of the administrator, where that decision is commercially justifiable by reference to the interests of the creditors. As the decision to retain staff is likely to be viewed by the court as a commercial decision in that it supports the rescue of the firm (and thereby returning the highest value to creditors), the court would be unlikely to uphold any claim.

Consultation question

19 Do you agree that a limited immunity from liability for administrators is unnecessary in the SAR?

Bloxham recommendations 19, 59, 33, 36, 38, 63, 64 – administrative and procedural issues

5.27 The review made recommendations intended to improve the functioning of the SAR in practice and recommendations to make administrative changes.

Financial Services Compensation Scheme (FSCS)

5.28 The review recommends giving the FSCS the right to sit on creditor committees,[22] and recommends that the government consider an industry funded compensation scheme to top up FSCS protection.[23] The procedure for creditor committees in the SAR is set out in Chapter 8 of the SAR Rules. As set out in 5.21 the SAR insolvency rules are to be updated and modernised, and the government would support a proposal to take this recommendation forward as part of

[18] Review, page 21
[19] Review recommendation, page 47
[20] Review recommendation, page 48
[21] Paragraph 74 of the Insolvency Act 1986
[22] Review recommendation 19, page 43
[23] Review recommendation 59, page 43

that work. In addition, the government would welcome views on the need for an industry funded compensation scheme to supplement FSCS protection.

Communication using email

5.29 The review recommends giving administrators the power to communicate with clients using email.[24] The requirements for electronic communication (i.e. email) are set out in Rules 295 and 296 of the SAR Rules. These Rules permit an administrator to communicate with clients using email, provided the administrator has obtained consent from the client to do so. The government supports the intention of recommendation 33, and would welcome views on what more could be done to enable administrators to communicate using email.

Reviews and updates

5.30 The review recommends establishing a mechanism to consider updates of CASS and the SAR.[25] The government agrees, and considers the BLP, a statutory panel established under the Act, to be an effective mechanism for monitoring changes in market practices and for identifying possible updates to CASS or the SAR. The BLP's advice has been sought on the government's proposed response to the review.

5.31 The review recommends removing the statutory requirement for an independent review of the SAR within two years of any changes being made to it.[26] The government supports this recommendation. As the review notes, the resources that would be spent carrying out an independent review could be more effectively directed to ensuring the regime is kept up to date. Furthermore, it is possible that no firms will enter the SAR in the intervening period, and so there would be little opportunity to learn new lessons from any application of the legislation. Implementation of this proposal goes beyond the scope of the amendments considered here.

Title and scope of the SAR

5.32 The review makes recommendations in relation to updating the scope of the SAR, and its title.[27] The government supports the review's recommendation that insurance brokers should continue to be excluded from the scope of the SAR. Further, the government proposes to bring alternative investment fund managers and trustees or depositories (AIFs) and Undertakings for Collective Investments in Transferable Securities (UCITS) managers and depositories back into scope of the SAR, if they hold client assets, after they fell out of scope as a consequence of implementing the AIFM Directive.[28] The proposal is set out in draft Regulation 2. The title of the SAR includes reference to "investment banks" because it flows from the Act's broad definition of "investment bank", which includes a variety of entities which hold client assets and have functions relating to safeguarding or dealing in investments. The government supports the principle of the recommendation to replace "investment bank" with "investment firm" in the Act – however, implementation of this proposal goes beyond the scope of amendments considered here.

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[24] Review recommendation 33, page 50

[25] Review recommendation 36, page 51

[26] Review recommendation 63, page 61

[27] Review recommendation 38, page 38 and Review recommendation 64, page 62

28 articles 42A and 72AA of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (S.I. 2001/544), which were inserted by the Alternative Investment Fund Managers Regulations 2013 (SI 2013/1773).

Consultation questions

20 Do you think an industry funded compensation scheme to supplement FSCS protection is necessary?

21 What are your views on the administrative and procedural proposals set out in paragraphs 5.27 – 5.32?

22 Managers and depositories of AIFs and UCITS were technically excluded from entry into the SAR by the AIFM Directive. Do you think returning them into scope of the SAR will result in any material additional costs for those entities?

Bloxham recommendations 57, 58 – the role of the authorities in the SAR

5.33 The review made two recommendations to the effect that the authorities should produce guidance on i) the factors that will determine which insolvency regime is selected in a given case, and ii) the roles of the FCA and PRA in SAR cases.

5.34 There now exist three possible regimes which an investment firm may enter when it fails: "ordinary" insolvency; the SAR; and the special resolution regime[29] (SRR) for investment firms whose failure would be likely to trigger the public interest test for the use of the regime's stabilisation powers. The review recommended that guidance be published explaining the differences between the various regimes and setting out the factors that will determine which regime is used.[30] In addition, since the SAR was introduced, the Financial Services Authority has been replaced by the PRA and the FCA. To ensure the smooth operation of a SAR administration, the review recommended the authorities produce guidance on the ongoing roles of the FCA and PRA, and how administrators are expected to work with them.[31]

5.35 The government supports these recommendation, and a Code of Practice ("the Code") setting out how the insolvency regimes operate and the role of the authorities is available on the Treasury website. The Treasury updates the Code on a periodic basis, in light of evolving experience and will consult the Bank of England, PRA, FCA and the FSCS on any changes. When making material changes to the Code the Treasury will also consult the BLP, which has a statutory remit to advise the Treasury on the Code under section 10(2)(b) of the Act.

Consultation question

23 What are your views on the suitability of the guidance that has been published in relation to the roles of the authorities?

[29] The Banking Act 2009 provides for a special resolution regime (SRR), providing the Bank of England, the PRA, the FCA and the Treasury with tools to protect financial stability by effectively resolving banks, building societies, investment firms, banking group companies and central counterparties that are failing, while protecting depositors, client assets, taxpayers and the wider economy.

[30] Review recommendation 57, page 58

[31] Review recommendation 58, page 59

6 Lessons learned

6.1 The review recommended that the government consider the key court judgements in the insolvencies of LBIE and MF Global, and analyse what lessons can be learned.[1] The court judgements primarily addressed questions about how the CASS distribution rules, general insolvency law and common law principles interact with one another, and in the case of MF Global, how this legislation interacts with the SAR. The government notes that since the review was published in 2014, 7 firms have entered the SAR.[2] The government would welcome views on the lessons that could be learned from these more recent administrations, and what changes could be made to the SAR to address them.

LBIE judgements

Scheme of arrangement judgement [2009] EWCA Civ 1161

Judgement summary

6.2 In this case administrators sought to overcome problems faced when returning client assets to their owners that arose because of the firm's poor records, and the failure of a large number of clients to put in claims in good time. They applied to the court for permission to propose a scheme of arrangement[3] to resolve this.[4]

6.3 The Court ruled that a scheme of arrangement could not be used in relation to client assets, because the powers only applied to creditors (i.e. persons with monetary claims as distinct from those with property claims). It held that it had no jurisdiction to allow a scheme of arrangement ordaining how assets were to be distributed, where the assets were held on trust by the firm, because clients have proprietary rights to those assets.[5]

Lessons learned

6.4 The inability to create a scheme of arrangements has exposed difficulties where, for instance, the firm's records do not identify who the assets belonged to, or there are shortfalls in total assets and it is not clear how the assets should be distributed. This case also reflects the different treatment by administrators of assets held on trust for the clients, and assets belonging to the firm, which are available for distribution to creditors.

6.5 The review recommended that the government consider whether schemes of arrangement could be made available to deal with proprietary claims against investment banks and overseas law governed contracts.[6] The government does not have power to make this change to the SAR Regulations. It would require the application with modification of Part 26 of the Companies Act 2006, which is not provided for by the enabling provisions in the Act (sections 232 to 234).

[1] Review recommendations 39, 40, page53

[2] In addition, City Equities Limited entered the SAR shortly before publication and was not considered for the purposes of what lessons could be learned.

[3] A scheme of arrangement is often proposed by a company to reach a compromise agreement with its creditors. The majority of each class of person affected votes on whether to approve the compromise, which must then be sanctioned by the Court before it can become effective.

[4] Under Part 26 of the Companies Act 2006.

[5] A claim for client money is a "proprietary" or property claim, because under CASS, beneficial ownership of the money remains with the client and is not passed to the firm. A client owed client money has a proprietary right to a share in the particular pot of money concerned, not just a monetary right to compensation. In contrast, a general creditor has a claim against the firm estate, i.e. the assets owned by the firm itself. The ruling in this case was that the statutory powers to make schemes of arrangements do not apply to proprietary claims.

[6] Recommendation 55 – Use of schemes of arrangement

6.6 The government has given consideration to the judgement in the context of the other policy proposal set out in this document. In particular, the proposals set out in chapter 3 to allow administrators to set a hard bar date would give an administrator additional reassurance when client assets have to be distributed in the knowledge that some clients have not put in claims that could be made. Like a scheme of arrangement, a hard bar date would extinguish proprietary rights, but only of clients who had not, for any reason, made a claim, and in accordance with safeguards described in the chapter. By contrast, a scheme of arrangement would extinguish the rights of people who were outvoted whether or not they were willing to make a claim in the administration.

Client money judgement [2012] UKSC 6

Judgement summary

6.7 This case focused on the interpretation of CASS. Client money that should have been segregated was not segregated, and it was not clear whether the unsegregated money constituted "client money" for the purposes of distribution[7]. The court ruled that the statutory trust for client money arises at the moment the firm receives the money and does not necessarily fail if it is not paid into a client bank account. Pooling at the date of the primary pooling event includes all client money identifiable as client money in the firm's house accounts. To this extent any client whose money should have been segregated has a right to share in the client money pool, irrespective of whether the money was actually segregated.

Lessons learned

6.8 The key consequence of this judgement is that administrators must identify any client money held in unsegregated accounts. Particularly where records are poor, this can be a complex and time-consuming task, and the amount so held may be disproportionate to the total value of the pool. Where money has been transferred through a number of accounts, it can become impossible to trace it irrespective of the resources devoted to doing so.

6.9 The government has considered these factors in developing its response to the review's recommendations, particularly in relation to the final reconciliation of firm and client accounts and records for pooling client money. A number of the policy proposals set out in this document will help to address the issues that have been raised. In particular:

- as set out in chapter 4, the government proposes that the administrator should have the power to top up the client money pool from monies in the firm account. This final reconciliation will reduce the need for the administrator to engage in expensive and time consuming tracing exercises
- there were particular problems in the LBIE case arising from poor recordkeeping. The FCA have since strengthened recordkeeping requirements in CASS. As set out in chapter 4, to the extent that firms have failed to comply with the CASS provisions, any additional costs arising will be borne by the creditors of the estate of the failed firm, rather than by clients
- there were further problems in the LBIE case arising from poor client response in making claims. The government's proposals for bar dates (chapter 3) would, when

[7] Under CASS rules, the firm must keep client monies separate from its own funds. When the firm receives money belonging to its clients, it must pay this into a segregated client bank account promptly (such account may be pooled with other clients' money, or designated to a particular client). Where the firm operates the alternative approach to client money, it may pay such monies into and out of its own accounts, as long as it ensures that the requisite amount is segregated each business day.

used, be likely to result in a more efficient process for clients' claims and distribution

MF Global judgements

The client money resolution application – [2014] EWHC 2222 (Ch)

Judgment summary

6.10 This judgment determined that MF Global, as trustee of the client money pool, had the power to "compromise claims" (i.e. to establish a comprise position) in relation to claims between the client money pool and the general estate. This enabled the administrator to reach a final settlement, so as to release all claims between MF Global as Trustee of the client money pool and MF Global's in its own capacity as an investment bank. This provided certainty as to the final size of each estate, to allow speedier return of client assets and faster pay outs to creditors from the general estate.

Lessons learned

6.11 This case highlighted the difficulties which administrators have to manage when representing an insolvent firm both as trustee of client money and the insolvent firm in its own capacity. As an example of these complexities, the firm as trustee of the client money pool is likely to have proprietary claims against the firm's general estate to client money which remains in its own accounts. Conversely, the firm may have claims against the client money pool for firm funds incorrectly allocated to the client money pool. The judge recognised the practical difficulties which would be encountered in tracing proprietary claims, as well as the length and cost of potential court applications which might be required to resolve the legal issues which would be likely to be encountered in the tracing process. Firms' ability to compromise claims in the circumstances outlined above should enable an administrator to return client assets and make pay-outs to creditors more quickly.

6.12 The government has considered whether further changes are needed to the SAR in response to the ruling. The government notes that trustees have the power to compromise claims under the Trustee Act 1925 and that the SAR Regulations give administrators power to compromise claims through the application of provisions of Part 2 of the 1986 Act. The government does not believe it is necessary to make further changes to the SAR in this area.

A new proving and distribution process for Client Money – MF Global UK Ltd (in special administration) (No 3) [2013] EWHC1655 (Ch)

Judgment summary

6.13 CASS deals with the holding and distribution of client money,[8] and the SAR deals with the distribution of custody assets. However, there is no process in CASS or the SAR for clients to make a claim for client money or for the administrators to adjudicate claims and make distributions based on the agreed claims. [9]

6.14 In this case, the administrators obtained a court order permitting them to distribute client money to clients whose claims they had admitted in accordance with a detailed proving and

[8] See CASS 7 and 7A

[9] This lack of certainty over the proving of and distribution of Client Money claims was an obstacle to providing clients with a "timely distribution" on their client money entitlement, in accordance with Objective 1 of the SAR. This is because a fair process must be followed before unfounded client money claims can be rejected, and the interests of clients with unresolved client money claims must be protected in any distribution of client money.

distribution process, to meet the difficulties posed by the existence of rejected claims and the possibility of unknown claims. The process proposed was adapted from the procedure set out in the SAR rules, which are based on the Insolvency Rules, for the submission and adjudication of claims by company creditors.

6.15 The court approved the administrator's proposed distribution procedure in exercise of its inherent jurisdiction to enable practical effect to be given to a trust. This permitted clients to receive a payment if their claims were lodged by the last date for making claims specified in a notice of distribution. However, a rejected claim would be admitted if the claimant had given notice of application to the court to vary or reverse the rejection, and the procedure did not exclude any claimant from a subsequent distribution if they could establish their claim. The procedure was also without prejudice to a claimant's right to trace an entitlement into other funds.

Lessons learned

6.16 As set out in this consultation document, the government is proposing to introduce provisions about the procedure for making distributions of client money which will reduce the need for obtaining court orders, provide greater certainty, clarity, speed, and reduce the costs of distributions. The key elements of these provisions are as follows:

- the administrator may set a bar date for a distribution of client money (as set out in chapter 3, and implemented by Regulation 12 of the draft Regulations, which inserts new Regulation 12A)
- if a bar date is set, prior distributions may not be disturbed by a late client money claim (draft Regulation 12A(4))
- clients are generally to bear the cost of distribution of client money, but regulation 14 of the draft Regulations, which inserts new regulation 19A in the principal Regulations, provides for costs to be met out of the bank's estate under certain circumstances involving the bank's failure to comply with regulations or rules about client money
- if, after returning client money so far as reasonably practicable after setting a bar date, there is a surplus in client money, this may be transferred to the firm's accounts under a hard bar date procedure implemented by draft Regulation 12 inserting new Regulation 12C).

6.17 In addition, the government notes that clients have the right of appeal against rejection under general insolvency law, and that administrators are able to make provisions for claims.

The hindsight judgement – [2013] EWHC 92 (Ch)

Judgement summary

6.18 This case focused on whether, as provided by CASS, the client's entitlement from the client money pool was to be quantified by reference to its value on the day of entry into administration (known as the "primary pooling event" – or PPE – date), or on a subsequent date when the contract ended. The court ruled that a client's CASS claim from the client money pool was to be valued as at the date of PPE.

Lessons learned

6.19 The judgment does not overturn the discrepancy between how a claim for client money from the client money pool is valued (based on the date of the PPE), and how the client's

parallel claim against the firm's general estate is valued (this valuation is made in "hindsight", that is by reference to the value of the contract at the time at which it closes). These claims arise out the same set of facts and are in substance claims in respect of the same liability. However, the different valuation methodology can lead to this same loss being valued differently according to whether the claim is for a shortfall in the amount due under CASS or is in contract. The government's response is considered below, and in chapter 4.

The shortfall judgement – [2013] EWHC 2556

Judgement summary

6.20 This case made findings about the three kinds of claim that a client who has client money held by the firm might be able to bring in the insolvency proceedings. The kinds of claim are:

- CASS claim. A client's first claim is for its share of the client money pool under the CASS 7A distribution rules. This is a claim under trust law. It arises from CASS, which requires firms to hold clients' money on trust for its clients. Currently, CASS requires a client money entitlement to be valued at the date of a primary pooling event, which includes a "failure" of the firm (e.g. the appointment of a liquidator or administrator etc.).
- Shortfall claim. Where there are insufficient funds in the pool to fully meet the CASS claim, there may be an unsecured claim for breach of trust. The claim would be for payment of the shortfall from the general estate, and the client would rank as a creditor alongside other unsecured creditors of the same class. The shortfall may arise for a number of reasons, including the firm's failure to segregate client money or placing of funds in another institution which has also become insolvent, leading to a loss of assets.
- Contractual Claim. The client may also make a claim in contract as an unsecured creditor of the general estate. The client's contractual claim runs in parallel to its CASS claim, based on the value when the contract ended e.g. a financial contract's close-out value (according to the "hindsight principle").

6.21 The court made the following rulings about these claims:

- The CASS rules are for the protection of contractual rights. The contractual claim is a personal claim against the firm's estate and the amount provable is reduced by the amount received from the client money pool. They are in substance claims in respect of the same liability. The shortfall claim is also provable against the firm's estate. The rule against double proof prevents a client proving for the shortfall and the balance of the contractual claim, except to the extent that the shortfall claim exceeds the contractual claim or where the client has no balance for a contractual claim ("the excess shortfall"). The amount of the excess shortfall is not reduced where a client's contract closes out at a value less than its value assessed on the date of the primary pooling event (for a CASS distribution). The client is still entitled to prove for an amount equal to the excess shortfall, because the liability is to pay equitable compensation for breach of the express duties in CASS.

Lessons learned

6.22 This ruling created a complex result that the review described as having required some "judicial ingenuity"[10]. An administrator has to deal with three types of claims from a client

[10] Review, page 18

arising out of one transaction, each of which is valued on a different bases. The time and effort involved in establishing and interrogating each of these claims will inevitably result in delays in returning client money. The review recommended giving consideration to adopting the hindsight approach for CASS claims to address some of the complexities resulting from this case. These issues are considered in more detail in chapter 4.

Recent administrations

6.23 As set out above, 7 firms have entered the SAR since the review was published[11] and one entered shortly before the review was published. The government would welcome views on what lessons can be learned from these more recent experiences, especially whether they have raised different issues from those exposed in previous administrations.

Consultation questions

24 Do you have any views on the lessons learned from the cases set out in this chapter?

25 Do you have any views on lessons learned from more recent cases?

Consultation questions – impact to business

26 Do you think the proposals in this consultation document will incur material familiarisation costs on a going concern basis for clients or creditors of investment firms, or for the investment firms themselves?

27 Do you think the proposals will incur material familiarisation costs for insolvency practitioners?

28 Are you able to identify any other specific elements of the proposals that would be likely to result in material monetisable costs to industry?

29 Are you able to identify specific elements of the proposals that would be likely to result in material monetisable benefits to industry (for example, overall cost savings arising from speeding the process of distributions?

30 Do you have any other views on the costs or other impacts of the proposals set out in this consultation document?

31 Are you able to identify any specific costs and / or benefits that would arise in relation to small business?

[11] At the time of writing.

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This document can be downloaded from www.gov.uk

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