HM TREASURY

Establishing resolution arrangements for investment banks

December 2009

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Executive summary

The world economy continues to feel the effects of the most severe financial crisis in over 60 years. Over the last two years, governments around the world have taken unprecedented steps to stabilise the financial system, and limit the wider economic fallout from the crisis.

There is now a general consensus that the point at which the financial crisis entered its most critical phase came after the failure of Lehman Brothers (Lehman) on 15 September 2008.[1] The collapse of Lehman tested to the limit the durability of the financial system in all major financial centres, including the UK. Regulatory and legal structures were placed under severe strain and the systemic consequences of Lehman's failure were felt throughout the global market.

In the UK, Lehman's counterparties were unclear as to whether over 840,000 trades would go on to settle, while clients had more than $35 billion in cash and assets tied up in the insolvent estate. The impacts on both market confidence and financial stability were severe. These problems were not unique to the UK, which was as well placed to deal with the Lehman failure as comparable jurisdictions. The severity of the fallout from Lehman's demise has, however, made the case for further action clear.

The UK, and London in particular, has a well-deserved reputation as one of the world's key centres for conducting investment banking business, and the Government is determined to protect and enhance this reputation. It is committed therefore to implementing a proportionate and considered response to the issues highlighted by the Lehman failure.

The Government published a discussion paper in May of this year, outlining its initial thinking on the steps necessary to improve the regime around the failure of investment firms. Since then, it has engaged in an extensive process of consultation with industry experts, including buy- and sell-side firms, insolvency practitioners, and legal experts. The Government has also worked closely with the Bank of England and the Financial Services Authority (FSA) to develop balanced and proportionate policy outcomes.

This consultation document provides further detail on the Government's thinking, and outlines a package of more than 30 policy initiatives designed to mitigate the impact of the failure of an investment firm.

The core of these proposals, as set out in Chapters 2 and 3, is a set of measures to enable the managed wind-down of an investment firm. These include the development of resolution plans for firms, a set of special administration objectives and new responsibilities to be placed upon the board. These resolution proposals underpin specific initiatives designed to achieve better outcomes for key groups affected by the failure of an investment firm. These aim to:

- speed up the return of client money and assets (Chapters 4 and 5);
- address counterparty exposures to the firm (Chapter 6); and
- ensure creditors are sufficiently protected (Chapter 7).

These proposals are designed to operate together as part of an integrated package of reforms. They respond to the specific challenges highlighted by the collapse of Lehman, but are also designed to be forward looking, and place the UK on a strong footing to deal with any future

[1] The Government published its detailed analysis of the causes of the crisis in *Reforming Financial Markets* in July this year.

failure of an investment firm. They should not be seen in isolation; the policies laid out in this paper form a key part of the Government's broader financial sector reform agenda laid out in the *Reforming Financial Markets* White Paper.

Enabling an orderly resolution

Chapters 2 and 3 of this paper set out policies to ensure that an investment firm can be wound down effectively with limited impacts on financial markets. These measures are designed to enable continuity across the operations of a firm at both a pre- and post-insolvency stage; and to ensure that key systems remain operational at the point at which the firm fails.

Chapter 2 lays out proposals for a new administration regime for a failed investment firm. This would ensure that the administration of a failed firm is conducted with due regard to financial stability and the proper functioning of markets, as well as with reference to the need for the speedy recovery of assets for clients and counterparties of the firm. The proposals include:

- special objectives for the administrators of investment firms which will create duties to place a procedural imperative on the reconciliation of client positions and other actions relevant to financial stability;
- a special defence from personal liability for administrators, in order to enable greater freedom of action in pursuit of the special objectives; and
- a special defence from liability for directors to enable them to implement resolution plans and address potential obstacles in the context of the pre-insolvency resolution process.

Chapter 3 builds on work HM Treasury, the FSA, and the Bank of England have initiated on recovery and resolution plans for individual firms. It highlights proposals for specific new requirements for investment firms, which would be mandated by FSA rules including:

- creating a role for 'business resolution officers' (BROs): specific duties may be placed on a board level officer of an investment firm with respect to firm-level resolution actions;
- requiring the implementation of 'investment firm resolution plans': these form the investment banking component of the resolution and recovery plans currently being legislated for in the Financial Services Bill, and relate specifically to actions the investment firm should plan for, both pre- and post-insolvency to enable its business to be wound down in an orderly manner;
- requiring firms to develop 'business information packs' (BIPs): produced and updated on an ongoing basis, BIPs would be a repository of information on an investment firm's operations and structure, for use by administrators in an insolvency;
- establishing continuity of service measures for staff and suppliers: these proposals would require firms to put in place certain contractual provisions, to ensure continuity of service from the firm's key staff and suppliers in the event of its failure; and
- requiring firms to hold liquid operational reserves: the Government proposes requiring firms to maintain adequate operational funding to pay key staff and service providers post-insolvency, to ensure continuity of key functions.

Reconciling and returning client money and assets

Building on the resolution proposals laid out in Chapters 2 and 3, the Government is proposing steps to improve outcomes for the clients of a failed investment firm. Clients are particularly affected, since their assets and money, to which they have a proprietary claim, can become trapped in the failed estate. It is important for the proper functioning of the market that such assets can be released to their beneficial owners as quickly as possible.

Chapter 4 sets out proposals to improve the protections for investment firm clients at a pre-insolvency stage. It considers the following measures:

- increasing clarity over the allocation of shortfalls in an omnibus account: clarifying the treatment of client assets on insolvency by ensuring the allocation of shortfalls in a client asset omnibus account are proportionate to their entitlement;
- mandating product warnings in contractual agreements: clearly setting out the implications of allowing rehypothecation and use of client omnibus accounts at custodian level;
- encouraging clarity in contractual agreements: encouraging investment firms to be transparent over any risks to client money and assets protection;
- increasing reporting and record-keeping requirements: requiring investment firms to develop capacity for daily reconciliation of client positions and exposures;
- increasing audited disclosures by firms around client money and assets: increasing disclosures by firms to the FSA around the holding of client money and assets;
- making client asset officers directly accountable: clarifying FSA controlled function 29, so that the FSA is able to ensure that the people in charge of directing client assets are fully qualified and capable of executing their duties;
- supporting the establishment of bankruptcy-remote SPVs for client assets: to ensure that the return of client assets is not affected by the insolvency proceedings of the investment firm;
- substantial limitations on the transfer of client money: placing limitations on the ability of investment firms to transfer client money to affiliate entities and jurisdictions where this would be incompatible with protections in FSA's *Client Assets Sourcebook* (subject to principles around free movement of capital);
- changing the regime regarding custodians' right of lien over client assets: ensuring that the custodian has no lien or right of retention over client accounts and that it will not seek to combine, net, or set off the account against the debts or obligations of the firm;
- requiring firms to have the capacity to divide client money into different pools: client money might be divided into different pools according to the type or risk of the investments involved; and
- establishing bar dates for client claims: creating a statutory scheme with fixed terms under which client claims have to be received. This should help speed up the process of determining clients' entitlements to assets and money.

Building on these proposals, Chapter 5 sets out the Government's proposals for the possible creation of the position of a client assets trustee. A trustee would have a role separate to the administrator of a firm in insolvency and would be tasked with prioritising the return of client assets and money. This would address concerns that clients' rights are not fully represented at present. The proposal for such a trustee could also possibly be complemented and augmented by the creation of a dedicated client assets agency; this option is also discussed in Chapter 5.

Reconciling counterparty positions

Chapter 6 sets out proposals to mitigate the impact of investment firm failure on the market counterparties of the firm. The proposals in this chapter are designed to improve the functioning of market infrastructure in the event of an investment banking failure. The key proposals discussed in this chapter are:

- an extension of protections similar to those afforded by Part 7 of the Companies Act 1989, to enable Multilateral Trading Facilities (MTFs) to deal centrally with a default, without risk of challenge from the insolvency practitioner;
- a market Protocol to address absence of default terms for some over-the-counter (OTC) cash equities trades, with regulatory action underpinning this if necessary;
- the introduction of a requirement that central counterparties (CCPs) offer a choice of account structure, enabling members to segregate their business;
- the introduction of a requirement for investment firms to offer facilities to segregate client business;
- action by Euroclear UK & Ireland, operator of CREST, to freeze pending settlement instructions in relation to an insolvent participant, giving greater certainty as to what will happen to unsettled settlement instructions; and
- market action to address uncertainties about aspects of the contractual terms under which investment firms and investment managers conduct business.

Broader context

The Government recognises that all of the proposals outlined in this document need to be considered in their broader context, both in terms of their impacts on the general unsecured creditors of the failed estate, and in terms of how the actions proposed will interact with steps taken in other jurisdictions.

Chapter 7 considers the impacts of the policies outlined above on the unsecured creditors of a failed firm. It also discusses possible changes to the International Swaps and Derivatives Association (ISDA) Master Agreement and options for risk management resource centres to support administrators.

Chapter 8 discusses the international context in which the proposals described in this paper are to be taken forward. It sets out the Government's high-level principles for further cooperation with our international partners to ensure effective treatment of cross-border investment firms.

Next steps

The Government welcomes input from stakeholders on the policy proposals laid out in this document. Specific questions – including on the quantification of the costs and benefits associated with individual proposals – appear throughout the paper; details of how to respond are laid out in Annex D. Based on the results of this consultation, the Government will publish detailed proposals, including draft secondary legislation as necessary, in 2010.

1 Introduction

1.1 The UK is one of the world's primary international centres for conducting investment business. Around half of European investment firm activity is concentrated in London[2] and, along with New York, London is a global leader in the provision of investment services. The activity of investment firms in OTC derivatives, foreign exchange trading, and prime brokerage, amongst other activities, contribute greatly to the UK's prominence as a global financial centre. The concentration of investment firms also contributes to a cluster effect, enhancing the UK's role as a hub for a broader range of financial services.

1.2 A number of factors contribute to the UK's strength as a centre for investment business. Key among these are the UK's location, skills base and language, as well as its robust market infrastructure. The UK's legal and insolvency regimes are also of particular importance. Strengths in these areas include:

- a tried and tested legal regime. English statute-based insolvency law dates from 1542, when the basic principle was established that all of a debtor's assets are available for creditors, and that these assets should be divided pari passu among his or her creditors;
- extensive trust law[3] provision which fills the gaps in the statutory regime. The statutory regime prescribes at a high level how client assets or money should be held by a firm, and the concept of a trust enables the court to work out who has rights over what in any given case, without each right having to be prescribed for specifically in statute; and
- an insolvency regime which seeks a fair outcome for all clients and creditors, and does not discriminate between domestic and international creditors.

1.3 Taken as a whole, these factors provide a robust framework in which both investors and investment firms can confidently conduct business in the London market. The Government recognises the importance of maintaining and, where necessary, enhancing these protections, which are important to the UK's reputation as a reliable and flexible market.

1.4 The failure of Lehman Brothers (Lehman) in September 2008 posed serious challenges for legal and insolvency regimes the world over. Some of these challenges were particular to the Lehman case. Many were not. It is clearly appropriate for all jurisdictions hosting a major financial services centre to look again at their regulatory and insolvency regimes following an event of this magnitude.

[2] *'International Financial Markets in the UK'*, IFSL, November 2009 http://www.ifsl.org.uk/output/ReportItem.aspx?NewsID=42

[3] Note that this paper, in its discussion of trust law in respect to the ownership of client assets, depicts the situation as existing under the law of England and Wales and of Northern Ireland; the position under Scots law differs to a certain degree in some respects, although the basic protections remain.

1.5 In the UK there were genuine difficulties in handling the insolvency of Lehman's main UK arm, Lehman Brothers International (Europe) (LBIE). Administrators, other insolvency officials and infrastructure providers faced difficulties in dealing with open positions, identifying and returning client assets, and reducing impacts on markets once the failing firm had entered insolvency.

1.6 Despite these difficulties, the UK has responded effectively to the unique circumstances of the LBIE failure. Looking to the future, the Government is committed to improving the UK's legal, regulatory and market framework where the LBIE experience has highlighted the need for reform. To this end, it took powers in the Banking Act 2009 to make regulations with regard to the insolvency of investment banks.

1.7 In May 2009, the Government published an initial paper on these issues, which identified areas in which reform was being considered. By opening these issues to wide consultation at an early stage, the Government has given market participants the greatest possible opportunity to contribute to the renewal and repair of the existing regime around the failure of investment firms.

1.8 This document provides further detail on the ideas that have emerged from this consultation process, which has included detailed engagement with an Advisory Panel of industry experts. The paper outlines the Government's policy proposals in detail, and seeks to gather views on these proposals, as well as information on the expected costs and benefits. The results of this consultation exercise will be brought forward in 2010.

The collapse of Lehman Brothers

1.9 The challenges of a large investment firm insolvency were illustrated globally by the failure of Lehman, and the more than 240 entities trading under its holding company, Lehman Brothers Holding Inc (LBHI). The two largest entities were Lehman Brothers International (LBI) in the US, and LBIE, in the UK.

1.10 Prior to its insolvency, Lehman was the fourth largest US investment firm. It operated an international affiliate structure, with LBIE (the UK arm) managing European investment banking operations for the group.

1.11 Early in the morning of 15 September 2008, LBIE was informed by its US parent company, LBHI, that it was preparing to file for Chapter 11 bankruptcy protection under US law. As a result of LBHI's global liquidity management, LBIE's operating capital was held with the parent and it was informed that this would not be released as usual on the morning of 15 September. That same morning, administration orders were therefore made in respect of each of LBHI's UK companies.

1.12 Lehman's failure undermined confidence in the banking system as a whole, leading governments around the world to provide exceptional levels of financial assistance to the global financial system. While this action has led to stabilisation in the short term, governments must now enact substantive reforms to ensure that, in future, a similar failure does not have the same impact on financial stability.

1.13 In the UK, the Lehman failure highlighted areas in which the process of resolution for an investment firm could be improved. These included:

- the need to clarify the protections already available to clients, creditors and counterparties of a failing investment firm under the existing UK regime;

- scope for greater precautionary action by a failing investment firm, prior to its entry into insolvency, to smooth the wind-down process;
- the need to improve continuity of an investment firm's infrastructure, services and staffing to enable a more orderly, efficient wind-down;
- scope to improve administrators' and trustees' abilities to access and control client assets post-insolvency, and distribute them once control is established;
- opportunities to reduce negative impacts on counterparties, by improving clarity and certainty at trading, clearing and settlement stages; and
- scope to reduce the impact on unsecured creditors of the destruction of the intrinsic value of the firm's estate as a result of its failure.

1.14 These issues prompted the Government's work in this area, and form the basis of the UK response to the Lehman failure. The UK does not operate a zero-failure regime for financial institutions, and the Government intends to ensure that, through taking steps in the areas highlighted above, it can make future failures more manageable and less damaging.

The UK response

1.15 The Government is taking forward a series of reforms to reduce the impact of major investment firm failure, working to deliver policy outcomes that ensure financial stability and market confidence, as well as the international competitiveness of the UK. Notwithstanding the clear need to act to enhance the current regime, the Government welcomes the progress that has been made in the administration of LBIE itself (see Box 1A).

Box 1.A: Administration of Lehman Brothers International Europe (LBIE)

On 14 October 2009, PricewaterhouseCoopers (PwC) published a six-month progress report on the Administration of LBIE. By 14 September 2009 the Administrators had:

- gained control over c.$40bn of securities and cash belonging to LBIE and its clients;
- returned $13.3bn to clients, as either cash or securities;
- instigated the release of $1.0bn of collateral to LBIE's clients from third parties;
- made material progress in reconciling and settling positions with some 1,400 of the c.6,000 counterparties;
- fully valued and reconciled over 840,000 trades that were pending or failed on 15 September 2008 (the date on which administration orders were made in respect of LBHI's UK companies);
- re-valued and reconciled the majority of LBIE's 158,700 over-the-counter (OTC) derivative trade legs; and
- filed, or were in the process of filing, gross claims against 20 affiliate Lehman entities worth c.$208bn.

Source: Lehman Brothers International (Europe) in Administration – Joint Administrators' progress report for the period 15 March 2009 to 14 September 2009.

1.16 The Government is aware of the great importance that market participants place on certainty of outcomes, and understands that investment firm failure is now regarded as a significant 'tail risk' by investors. It is appropriate therefore that the Government should take steps to address these issues.

1.17 The Government believes, however, that it is neither feasible nor desirable to fully address all of the negative impacts of a failing investment firm. As indicated above, the UK does not operate a zero-failure regime for financial institutions, and it remains incumbent upon the directors and shareholders of any firm to ensure that it is run effectively to avoid failure. Similarly it is incumbent upon counterparties and clients to judge their own exposures to individual firms and manage their risk accordingly.

1.18 The Government also notes that the issues surrounding investment firm resolution are highly complex, and cut across a range of areas including the protection of property rights and the effective operation of market infrastructure. There is, therefore, no single solution to the issues raised by Lehman's failure.

1.19 This document sets out more than 30 substantive proposals for improving the resolution of investment firms. These include legislative, regulatory and market steps. The Government believes that, wherever possible, flexible and adaptive market solutions should be sought, but stands ready to implement legislative changes if needed.

1.20 The Government's policy proposals are designed to benefit the clients, counterparties and creditors of a failed investment firm, as well as to maintain financial stability and the effective functioning of markets. They centre on a set of steps to enable the managed wind-down of an investment firm, including resolution plans and special administration objectives. These steps are designed to ensure the effective resolution of an investment firm, and are laid out in Chapters 2 and 3 of this document.

1.21 These core, cross-cutting, proposals underpin a further set of policy initiatives designed to achieve better outcomes for key groups affected by the failure of an investment firm. These will have the effect of ensuring that:

- the assets and money held on trust by an investment firm can be returned to clients as quickly as possible (as set out in Chapters 4 and 5);
- trades that the failed firm has entered into can be resolved effectively to ensure clarity for affected counterparties (Chapter 6); and
- creditors are sufficiently protected (Chapter 7).

1.22 Finally, the Government proposes a set of principles for ensuring that these proposals can be taken forward effectively in collaboration with the UK's international partners (Chapter 8). All of this work is designed to reduce the impact of the failure of investment firms. It should be seen in the context of the Government's broader work on financial stability, which has focused on reducing the likelihood of failure, and reducing the impact of failure in systemic firms (see Box 1B).

Box 1.B: The Government's broader work on financial stability

The proposals in this document form part of a broader package of policy steps to ensure stable and competitive markets. Measures in this area were outlined in January 2008 in *Financial Stability and Depositor Protection: strengthening the framework*, in the Turner review in March 2009, and in the Government's *Reforming Financial Markets* paper in July 2009. These steps focus on reducing the likelihood of failure, and reducing the impact of failure and include:

- the establishment of a statutory Council for Financial Stability to monitor domestic and international matters influencing the stability of the UK;
- the introduction of stronger objectives and powers for the FSA, including an additional objective for financial stability;
- provisions to implement agreements by the G20 and Financial Stability Board (FSB) and take forward recommendations from Sir David Walker's review of corporate governance, aligning remuneration with risk management and increasing transparency;
- work with international counterparts to increase the quality and quantity of capital held by banks and the capital requirements for riskier trading activities, and to ensure adequate liquidity provision;
- measures to increase the effectiveness and intensity of supervision of banks, monitoring their business and risk to ensure they remain stable – through the FSA's Supervisory Enhancement Programme; and
- action by the FSA on bankers' pay and bonuses, to ensure they are effectively rewarded for long-term, sustainable growth, not short-term, paper profits.

The Financial Services Bill provides for an FSA duty to make rules requiring financial firms to produce Recovery and Resolution Plans, such that firms have clear contingency plans in times of failure. The Banking Act 2009 gives the Authorities permanent powers to intervene when the likely failure of a bank or deposit-taking institution threatens financial stability, the protection of depositors' money, or the interests of the taxpayer.

Scope of reforms

1.23 This paper is concerned with the failure of major firms conducting investment banking activities. The term "investment bank", while in common usage, has no fixed definition: the document consequently refers to "investment firms". The term as used in this paper is based upon the definition laid out in the Markets in Financial Instruments Directive (MiFID), as: "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis."

1.24 The Government has consciously adopted a broad definition of investment firms, as it intends the proposals to apply, in principle, to any institution conducting investment activities on a regular basis. However, in developing the policies laid out in this document, the Government has been particularly concerned with large firms that are likely to have an impact on financial stability. It notes the need for any policy proposals to be applied proportionately, and to avoid placing undue burdens on smaller firms.

1.25 A core proposal, laid out in Chapter 2, is to create a special administration regime for investment firms. For this proposal, a more precise definition of investment firm is needed. The regime would be established under the powers laid in the Banking Act 2009, which defines an investment firm (referred to as an "investment bank" under section 232) as an institution satisfying the following conditions:

- Condition 1: it has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on the regulated activity of: safeguarding and administering investments; dealing in investments as principal; dealing in investments as agent.
- Condition 2: the institution holds client assets.
- Condition 3: the institution is incorporated in, or formed under, the law of any part of, the United Kingdom.

Question 1

Do you have any comments on the proposed definitions of investment firm for the purposes of this work?

The consultation process

1.26 The Government received more than 25 responses to its May discussion paper. Since the consultation period ended in July, it has engaged extensively with industry, through multiple meetings of the Advisory Panel and a number of technical working groups constituted under it. The results of that consultation process are reflected in the text of this document, and in the proposals developed.

1.27 The purpose of this consultation document is to seek stakeholder feedback on the detailed policy proposals for resolution of a failing investment firm. The proposals it contains will be of interest to investment firms, and anyone who interacts with them. It will be of particular interest to the counterparties, clients and creditors of investment firms, and to insolvency practitioners operating in this sector. It may also be of interest to those who invest their money or assets with managers who in turn use investment firms to gain access to financial markets.

Approach to quantification

1.28 The Government is committed to cost-benefit analysis of its proposals, to ensure they achieve their goals in the most proportionate and effective way possible. Successful cost-benefit analysis depends on obtaining sufficient, high-level data from market participants as to how various measures would impact on them. Accordingly, the Government includes specific questions on costs alongside questions on the policy measures outlined in this document. For each proposed measure, the document sets out an initial cost estimate derived in conjunction with industry stakeholders, and invites feedback.

1.29 The Government strongly urges the industry to consider these cost estimates and provide feedback if necessary. These numbers will form the basis of an impact assessment in the next document, and will inform decisions about how policy should develop. It should be stressed that figures are initial estimates derived in conjunction with industry, loosely based on the average cost to an affected firm. Further work will be necessary to establish the range of outcomes likely for different sizes, and types, of firm and to scale this information up for the economy as a whole.

Next steps

1.30 Following this consultation document, the Government will be making decisions on which proposals to take forward, based on the responses received and its own analysis, including cost-benefit analysis. A further document with firm proposals, and draft legislation, will be published in 2010. In addition, the FSA will publish a consultation document on client assets and money in early 2010, taking forward further work on some of the policy proposals laid out in Chapter 4 of this document.

2 Enabling an orderly resolution

2.1 In Chapters 2 and 3 of this document, the Government proposes a comprehensive package of measures aimed at enabling an orderly resolution of a failed investment firm. The Government believes that a fast and effective wind-down process will enable better outcomes that minimise disruption to the markets, and limit impacts on the firm's creditors, clients and counterparties.

2.2 This chapter explores existing insolvency legislation, the extent of potential problems in relation to investment firm insolvency, and the scope to address these through legislative changes and other actions by the Authorities. The next chapter discusses the scope for addressing resolution challenges through regulatory and market actions. The measures outlined in these two chapters will provide the Authorities with tools to:

- provide options for unwinding the business of a failing firm, without requiring recourse to public funds;
- contribute to the efficient functioning of markets and maintain financial stability when an investment firm is in distress or has failed;
- improve outcomes for clients, counterparties and general creditors (as outlined in subsequent chapters); and
- maintain the international competitiveness of the UK.

2.3 In this chapter, the Government sets out its proposals for creating a special administration regime for investment firms. These legislative changes will provide greater legal clarity and help to overcome specific hurdles in the effective resolution of investment firms, as discussed below. Specifically this chapter covers:

- the creation of a special administration regime for investment firms, including special administration objectives, a special defence against liability for directors acting on the firm's resolution and for administrators acting according to the proposed special administration objectives; and
- actions by the Authorities to secure an effective and coordinated response to investment firm failure, including planning for effective communication to the market.

2.4 In Chapter 3, the Government presents a framework for consultation on market and regulatory actions, emphasising firms' responsibility to prepare themselves for failure so that their business can be wound down in an orderly manner. This will aim to cushion the impact of their failure in the period leading up to and immediately after insolvency.

2.5 The table below highlights the resolution proposals set out in Chapters 2 and 3.

Table 2.A: Reducing the impact of investment firm failure – resolution mechanisms

Actions by Authorities (Chapter 2)	Entity-level actions (Chapter 3)
Special administration regime Special administration objectives Administrators' liability Directors' liability: freedom & responsibility Removing legal barriers to provision of intra-day support by the market Other actions Communication plans Resource centre for administrators Dealing with cross-border firms	Actions to be outlined in FSA regulations Business resolution officers Investment firm resolution plans Business information packs Continuity of service arrangements – staff and suppliers Operational reserve

Special administration regime for investment firms

2.6 Investment firms are a core part of the national and international financial infrastructure, and among other things, play a critical role in providing market liquidity. A freezing of credit markets and a substantial strain on financial stability have followed the recent failures of investment firms, along with the failure of retail banks.

2.7 The Government believes that there is a strong case for a special administration regime for investment firms, to ensure that there is minimum disruption to financial markets as a result of their insolvency. The Government believes that current insolvency legislation under the Insolvency Act 1986, while generally robust and flexible, presents specific legal constraints for the effective resolution of large and complex investment firms.

2.8 This is a consequence of the complexity of investment firms' business, with balance sheets generally consisting of money and assets held on trust for clients, complex counterparty and financing positions, and collateral assets and liabilities in addition to other assets and liabilities. A single external party can have multiple types of claims on the assets of the investment firm at any given time. In many cases, rights of set-off and netting exist that pose difficulties for reconciliation.

2.9 In a normal insolvency procedure, the company's assets are distributed amongst the creditors according to a statutory ranking, with the assets being distributed first to the firm's secured creditors, then to preferential creditors (employees and occupational pension schemes), then to unsecured creditors and finally to common equity holders. However, in the case of investment firms, there are obstacles to the reconciliation of this ranking, as administrators face substantial difficulties in:

- determining the nature of liabilities (for example, whether they relate to trust property, and so are not company assets, or to secured or unsecured claims);
- determining the value of liabilities (for example, whether the close-out value for a complicated derivatives transaction claimed by a counterparty is valid);
- recovering assets (for example, client assets held with custodians); and

- returning these assets. Under the current insolvency regime, the statutory objectives of the administrator to work to achieve the best result for the creditors as a whole could lead administrators having to secure a high degree of confidence before taking decisions related to the return of assets or the management of the estate. A delay in reconciling claims could be compounded by the personal liability on administrators.

2.10 These difficulties exacerbate the problems discussed in Chapter 1, around the problems facing the clients, counterparties and creditors of a failed investment firm. Steps are therefore needed to provide clarity around the insolvency process for administrators and market participants so that the resolution process can be expedited.

2.11 The Government proposes a special administration regime for investment firms. This will take the form of an administration procedure with special administration objectives, and a clarification as to the liability of the administrators appointed under this new regime. The aim is to provide administrators with clarity and direction to manage the firm's wind-down, without needing to approach the court on a frequent basis. These adjustments to current insolvency law will aim to make the process less expensive and disruptive for an investment firm, its clients, creditors and the markets.

2.12 As emphasised in the May consultation paper, it is important that work in this area respects the framework of existing and well-developed insolvency practices in the UK. This includes the overarching principle of equal treatment of creditors, which ensures that foreign creditors are treated the same as domestic creditors. The Government will take an approach similar to the one taken in Parts 2 and 3 of the Banking Act 2009, in applying all relevant provisions of the Insolvency Act 1986 to the special administration regime for investment firms, but with necessary modifications.

Special administration objectives

2.13 The special administration regime for investment firms will be based on special objectives for administrators to pursue in unwinding the firm's business. These proposed special administration objectives (SAOs) will aim to provide precedence to certain activities that administrators would have to focus on, with a view to expediting the return of trust property, and providing certainty to counterparties as well as unsecured creditors about the return of their assets.

2.14 This will serve to address the inherent difficulties that administrators face in reflecting the interests of both the general creditor pool, and clients of the firm owed client money and assets, whom the administrator cannot currently legally prioritise.

2.15 The Government's Investment Banking Advisory Panel has indicated that it is important for any special objectives to be:

- clear, and to explicitly indicate that they do not aim to change ordinary creditor rankings;
- specific, to prevent litigation against the administrator for actions taken to meet the objectives and to provide a degree of confidence to the market as to their likely actions;
- interrelated, giving the administrator clarity as to priority where they potentially conflict;
- comprehensive, but to an extent that does not complicate their interpretation; and
- flexible, so that they remain relevant over time.

2.16 In line with the principles outlined above, the Government is proposing SAOs that are procedural in nature, providing a degree of clarity and flexibility to administrators of investment firms. The proposed SAOs would require the administrator to:

1. Prioritise the return of client money or assets (which could be specified in terms of cooperation with a Client Asset Trustee, should a separate trustee be established as proposed in Chapter 5). This would be similar to the first objective in the Bank Insolvency Procedure (BIP) in the Banking Act 2009 with respect to the prioritisation of depositor payouts.[4]

2. Provide services and facilities to businesses transferred both in the run up to and post-insolvency. This objective could be specified in a manner similar to that in the Bank Administration Procedure (BAP) in the Banking Act for deposit-taking institutions, which contains continuity of service obligations for administrators of any residual entity being wound down, to support a commercial purchaser or rescued parts of the business[5] [6]. Any such provision incorporated in the SAOs for investment firms would complement the continuity of service provisions in contracts with key suppliers, as outlined in Chapter 3.

3. Ensure timely engagement with market infrastructure bodies and the Authorities. The administrators would have to ensure that market infrastructure bodies such as payment and settlement systems and clearing houses are provided relevant information on a timely basis.

4. Wind-up the investment firm in the best interests of creditors as a whole.

2.17 The Government has considered a spectrum of alternatives for developing SAOs for investment firms, ranging from a prescriptive set of special objectives to making it a primary duty of administrators to focus on minimising market disruption and financial instability. The Government has also considered objectives outlined in other special administration regimes, including the BIP and BAP for deposit-takers, and the energy special administration regime under the Energy Act 2004 (greater detail on issues related to interaction between these proposals and the Banking Act 2009 can be found in Box 2.A below).

2.18 The Government is proposing that SAOs are procedural in nature, as outlined above, because while a prescriptive list of objectives would provide certainty, it may also be restrictive and may not remain relevant with the passage of time. Objectives based on broader concepts of financial stability would provide more flexibility to administrators, but could also create legal uncertainty as to what actions they are likely to take.

2.19 In addition, the Government notes that there are specific concerns that may arise in relation to any form of special administration regime, particularly ensuring that general creditors are not affected disproportionately, and that implementation of the regime is effective.

Ensuring creditors are not disproportionately affected

2.20 As the SAOs are based on a principle of 'precedence' rather than one of 'preference'; they will be specified in such a way as to preserve existing creditor rankings under the current insolvency law relating to administration. One consequence of giving precedence to the distribution of client assets as set out above is that distributions to unsecured creditors may be delayed and this could potentially result in some loss of value to the general creditors in terms of

[4] See Box 4.E of the May consultation document, *Developing effective resolution arrangement for investment banks,* HM Treasury, May 2009

[5] In the case of the BAP, this would be a bridge bank.

[6] The special administration procedure could specify the kind of transfer agreements to which the objective refers, to enable the administrator to determine which transfers made in the period leading up to the insolvency are to be supported under this objective.

the opportunity cost of capital. However, the Government is of the view that the increased certainty and confidence created through an orderly wind-down process based on the SAOs is likely to be beneficial for unsecured creditors, offsetting some of the temporal impacts of distribution.

2.21 The SAOs may replicate the type of provision in section 99 of the Banking Act 2009, which explains how objectives for depositor protection and creditors as a whole fit together. In the case of investment firms this would mean that the objectives as specified above could take precedence over the winding up of the bank in the interests of creditors as a whole, but the administrator could be obliged to begin working towards all objectives immediately upon appointment.

Ensuring effective implementation

2.22 The Government has also considered additional factors that are likely to be important for the SAOs to be implemented effectively. The special administration regime may need to provide a mechanism for the administrator to resolve both creditor and client asset claims speedily if they are reasonably certain of the validity of the claims. One way of speeding up the process could be to include a cut-off date for client claims – a "bar date", as discussed in Chapter 4. In Chapter 5, the Government proposes a mechanism for enabling a rapid payout of the estimated client money and assets due to a client. In that chapter, the Government also proposes an option for setting up a separate client assets trustee (CAT) within the special administration regime who would be responsible for the pursuit of objective 1 above. The administrator and CAT would be required to cooperate with each other as outlined in the chapter.

2.23 Administrators may also face practical obstacles to winding up the estate in the best interests of creditors; the Government is taking steps to ameliorate these and to mitigate negative externalities for unsecured creditors from the proposals in this document, as outlined in Chapter 7 and in the section on intra-day support below. The Government will also consider whether there is a case for including provisions in the special administration regime for financial disincentives if counterparties have provided unreasonable close-out valuations on derivatives transactions to administrators as discussed in Chapter 7.

2.24 Special provisions around the liability of administrators and directors, which the Government proposes be incorporated within the special administration regime for investment firms, are discussed below.

Question 2

Do you agree with the Government's proposals for special administration objectives and associated policy measures? Are there any supporting levers not considered in this document that would be critical for the effective functioning of the special objectives?

Amending administrator liability

2.25 In the May consultation paper, the Government asked whether the personal liability faced by administrators might inhibit them from processing outstanding trades or releasing client assets as speedily as possible, thereby affecting the return to clients, counterparties and general creditors. For the swift and effective resolution of investment firms, administrators may need to be able to return assets on the basis of high, rather than absolute, certainty. Based on responses to this consultation, the Government is of the view that changes around administrator liability in respect of the special administration regime will contribute to the effective resolution of investment firms.

2.26 The Government believes that this issue is particularly relevant in the case of large, complex investment firms, for the following reasons:

- the level of complexity and the scale of the insolvency in the case of investment firms is likely to be significantly larger than for other types of firms (as the insolvency of Lehman Brothers International (Europe) (LBIE) has demonstrated), leading potentially to substantial personal liability accruing in an unforeseen manner;
- the risk exposures of open house and client positions can be significant for an insolvent investment firm and, in dealing with these, the administrators are exposed personally to much larger sums than they would in the administration of a non-investment firm; and
- it is important that administrators are not subject to liability for steps taken in pursuit of the SAOs.

2.27 Administrators generally act as agents for the entity in administration and therefore any actions taken would be in the company's name and paid for through the company's funds. Administrators' personal liability stems from paragraphs 74 and 75 of Schedule B1 of the Insolvency Act 1986.[7] In particular, the concerns identified in paragraph 2.26 stem from an action brought under paragraph 75.

2.28 Under the current insolvency regime, administrators have various types of protection from personal liability, for example, through their ability to negotiate contractual protection or their statutory discharge from liability at the end of the administration. The Government proposes extending these in the proposed special administration regime for investment firms, as set out below.

Proposed changes

2.29 The Government has discussed with the Advisory Panel different options for modifying liability under paragraph 75 of Schedule B1 of the Insolvency Act 1986. The Government is proposing introducing a special defence, or barring actions by creditors in certain circumstances. As discussed, the Government's approach will be to apply all relevant provisions of the Insolvency Act 1986 to the special administration regime for investment firms, but with necessary modifications. Full details as to these provisions are to be provided in the next consultation paper, expected during the course of 2010, which will set out the text of draft regulations.

2.30 One way in which administrator liability could be modified is for paragraphs 74 and 75 to be applicable under the regime, but suitably amended to provide a limited restriction to the liability of the administrator. Creditors could be restricted from taking action against administrators in certain circumstances, related to administrators' actions in pursuit of the SAOs.

2.31 Discussions with stakeholders have also revealed that a lack of clarity on the extent of administrator liability compared to that of directors is likely to fetter an administrator's ability to take action. It has been suggested that the personal liability of administrators to the company should not be greater than that of the company's directors before the company went into insolvency. The Government welcomes views on a case for such a proposition and how this can be achieved.

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[7] Under these provisions, a creditor can bring an action against an administrator, claiming that: (a) the administrator is acting or proposes to act in a way that unfairly will harm the interests of that creditor (paragraph 74); or (b) the administrator has misapplied or retained money or other property of the administration, has become accountable for money or other property of the company, has breached a fiduciary or other duty in relation to the company or has been guilty of misfeasance (has performed a lawful act, but wrongly) (paragraph 75).

Question 3

What are your views on introducing a limited restriction to the liability of the administrator, restricting creditors from taking action in certain circumstances, related to administrators' actions in pursuit of the SAOs?

Question 4

What are your views on the suggestion that the personal liability of administrators should not be greater than that of the company's directors before the company went into insolvency?

2.32 The Government is also considering whether the special administration regime for investment firms should specify a modified court process to approve certain of the administrator's actions, in order to provide certainty to the administrator and creditors. A creditor could only take limited action against an administrator in respect of an approved action – where the administrator has committed a misfeasance for example. In providing for this, the Government will ensure that any approval is specific and related to actions under the SAOs, reducing the potential for disputes as to its interpretation.

2.33 In addition to this provision, the Government is considering whether to provide for an expedited court procedure, where the administrators could apply at short notice for approval of actions related to the return of assets, where they are reasonably certain about the reconciliation of claims.

Question 5

Do you agree with the Government's approach to the court process for clarification around liability? What kind of expedited court process could be considered? Should one be required?

Other considerations

2.34 The Government is mindful that there are good reasons to retain administrator liability, in order to protect creditors against, for example, the misapplication of money or breach of fiduciary duty by the administrator, among other things. Therefore, the Government does not propose a complete removal of liability.

2.35 The Government believes that providing such clarity around administrator liability as proposed above will help reduce the risk of action being taken against an administrator by a creditor. As well as reducing the exposure of administrators, this clarity should also reduce the number of actions brought by creditors, which have the ability to disrupt the entire process. The disruption would otherwise lead to substantial expense of time and cost to the estate and its creditors as a whole, and potentially damage market stability.

2.36 While administrators' liability is not the predominant factor in causing delay during the insolvency proceedings for investment firms, it is a contributing factor that needs to be addressed. The Government recognises that professional reputation and prudence might be equally important factors in determining the speed with which administrators make decisions.

However, an additional defence might be useful in those decisions where administrators have to make judgement calls and are reluctant to do so under the current liability regime, preferring to gain absolute, rather than high, certainty over the value of assets and liabilities.

Question 6

Is there any other approach the Government could consider with respect to the modification of administrator liability for the purposes of the special administration regime for investment firms?

Freedom for directors to implement resolution actions

2.37 In the May consultation paper, the Government indicated that it would also review directors' liability under the Insolvency Act 1986, where there is a strong incentive for them to declare insolvency as soon as they are aware that the company is unlikely to avoid insolvent liquidation. The Government proposed determining whether directors of investment firms should have greater discretion on the timing of insolvency initiation, to enable a longer period of handover to administrators.

2.38 A longer handover would allow administrators time to familiarise themselves with the complexities of the investment firm's business. Recent experiences have suggested it may be helpful for administrators to be involved in the resolution process a few days before insolvency is declared, to minimise the disruption to markets and creditors.

2.39 The Government understands that directors may be reluctant to delay putting the firm into insolvency as this could expose them to personal liability. Therefore, through the special administration regime, the Government proposes making discrete modification to insolvency legislation (and other legislation concerning directors' duties) to overcome the obstacles specific to investment firm resolution, recognising that directors' fundamental duties towards the firm and its stakeholders should remain unchanged for these purposes.

2.40 As will be discussed in Chapter 3, the Government has developed proposals for the introduction of investment firm recovery and resolution plans to facilitate an orderly wind-down before the declaration of insolvency. One component of the investment firm resolution plans could consist of a period of one or two days when the directors of the investment firm and a proposed business resolution officer (BRO) could implement market-facing actions to close out the firm's positions and start unwinding the business before insolvency is declared. It is possible that administrators or others may challenge the directors or the BRO with respect to some of these actions. For example, if the director attempts to sell some of their assets under resolution plans to be able to reconcile positions or raise funds, this may risk being challenged as a transaction at an undervalue, or as a gratuitous alienation.

2.41 As set out here, the modification to insolvency legislation around directors' liability would delay insolvency by a few days as directors start unwinding the business. The Government believes that although this is a deviation from current insolvency principles, it is important from the point of view of financial stability and an orderly wind-down. The proposal would provide directors and creditors of investment firms, as well as Authorities and the market, with greater certainty and legal clarity about directors' actions.

Proposed changes

2.42 Under the current legal regime, directors have to make a judgement call regarding the initiation of insolvency. They can be held personally liable under section 214 of the Insolvency Act 1986[8] if they do not take action to put the company into administration or liquidation at the point where they knew or ought to have concluded that there was no reasonable prospect of its recovery. However, directors have a defence available if they are able to satisfy the court that, after they knew that the firm would not avoid insolvent liquidation, they took every step to minimise the potential loss to the company's creditors that they ought to have taken.

2.43 The Government proposes extending this defence for directors of investment firms to enable the implementation of investment firm resolution plans – creating an additional defence if directors are able to satisfy the court that their actions were specific to resolution plans or other resolution actions as agreed with the FSA. This defence would be part of the proposed special administration regime for investment firms, which would incorporate the relevant parts of existing insolvency legislation in relation to the actions against directors outlined above (including provisions currently only actionable by liquidators), but with necessary modifications.

2.44 In addition, an administrator or a liquidator can bring an action on behalf of the company against a director for breach of the director's common law duties or statutory duties. The Government proposes applying such provisions to the special administration regime, but with modifications so that action taken by a director under the resolution plan could not be actionable under the above except in limited circumstances where it would be appropriate for action to be brought.

2.45 For investment firms where the special administration regime does not apply, the Government would make specific changes to the above provisions of insolvency law to apply for directors of investment firms when they take action to implement the resolution plan.

2.46 With respect to other entities taking action against the directors, the special insolvency procedure would apply the provisions of the Insolvency Act 1986 (and other enactments whose provision relate to insolvency, for example the Directors Disqualification Act) so that the special defence applies where persons other than the administrators or liquidators bring an action against the directors.

2.47 There may be concerns that changes in directors' liability will be detrimental; for example, it could lead to concerns about directors using these modified provisions to cover up fraud. The Government would like to emphasise that under these provisions, directors' duties under the Insolvency Act 1986, as well as statutory duties under other legislation, for example the Companies Act 2006, would be maintained.

[8] Under the Insolvency Act 1986, certain actions are only actionable in a liquidation – section 212 (remedy against delinquent directors), section 213 (fraudulent trading), section 214 (wrongful trading) – which allow the Court, on the application of the liquidator, to declare that the individual has to compensate the estate for the money that he/she has misappropriated. Furthermore, an officer of a company could commit a criminal offence under section 206 (fraud in anticipation of the winding up) and section 207 (transaction defrauding creditors) of the Insolvency Act, punishable by imprisonment or a fine.

Question 7

Do you agree with the Government's approach in providing a special defence for directors of investment firms against actions taken by administrators and others, to enable directors to implement resolution plan actions in the interests of the firms' creditors and of financial stability? What specific modifications could the Government consider applying?

Initiation of the special administration regime

2.48 The Government proposes that only the FSA should be able to make an application for the court to appoint an administrator for the special administration regime for investment firms proposed here. If the institution is an investment firm within the definition in Chapter 1 (paragraph 1.25), then the FSA should only consider making an application if, following consultation with HM Treasury and the Bank of England, it determines that all the following conditions are fulfilled:

- Condition 1: the investment firm is failing, or is likely to fail the threshold conditions of its permission to carry out regulated activities, and it is not reasonably likely that action will be taken by or in respect of the firm that will enable it to satisfy the threshold conditions;
- Condition 2: the investment firm is unable, or is likely to become unable to pay its debts, and the order is reasonably likely to achieve the SAOs; and
- Condition 3: putting the investment firm into the special regime is necessary, where delay in the return of client money or assets or the disruption to the resolution of counterparty assets would have the potential to affect the stability of the UK's financial system, or to affect public confidence in the provision of financial services in the UK.

2.49 The conditions proposed here are consistent with the existing provisions of the Banking Act 2009 in relation to the BIP and BAP, as well as conditions for general administration. Box 2.A further below describes the Government's proposed approach to deal with the insolvency of an investment firm if it also held permission under the Financial Services and Markets Act 2000 (FSMA) as a deposit-taker.

2.50 There is a risk that any definition of investment firms embedded in legislation would become irrelevant by the time of another 'investment firm' failure, as the nature of entities and activities in the market is likely to evolve over time. The Government therefore proposes to review the definition regularly, and to make changes to it if necessary after consultation with a panel of experts.

2.51 The timing around initiating the special administration regime for investment firms may be important in determining the extent to which the process is orderly, with minimum impacts on financial stability. There needs to be a smooth transition between any resolution actions that the firm takes and any insolvency proceedings, avoiding a sudden collapse of the business.

2.52 Under current insolvency law, a company that is an authorised person under FSMA can be put into administration by the court on application by its directors, creditors, or the FSA; or directly by its directors or by its shareholders.[9] The Government would, however, seek to curb

[9] In addition to this, a company which is an authorised deposit taker may alternatively be put into bank insolvency on the application of the Bank of England, the FSA or the Secretary of State.

any disruption to the resolution plans (discussed in Chapter 3) being implemented by the firm under the supervision of the Authorities, from an application for insolvency that is made by a director or creditor. The Government proposes for this requirement to apply in the case of all investment firms. This would allow the FSA time to determine whether the special administration regime for investment firms would apply to the firm in question based on the considerations in paragraph 2.48.

2.53 Such an approach has been taken in the Banking Act 2009, where the court cannot grant any order for liquidation or administration without the FSA having been given two weeks' notice.[10] This would not affect creditors' rights; creditors would have to give adequate notice to the FSA. If the Authorities chose to not take any action, the creditor would be able to continue with their application.

Question 8

Do you agree with the proposals for the initiation and scope of the special administration regime for investment firms and its interaction with the provisions of Part 2 of the Banking Act 2009, as described in Box 2A?

[10] See section 120. This is in order to allow the Authorities to consider whether to apply a stabilisation tool under Part 1 of that Act in respect of that bank, or whether to put it into bank insolvency.

Box 2.A: Interaction of the investment firm special administration regime with Part 2 of the Banking Act 2009 – the Bank Insolvency Procedure

The Government has actively considered how the special administration objectives laid out in this document would interact with the provisions of Part 2 of the Banking Act 2009. Proper coordination as to which regime should apply will be important in cases where an individual firm both conducts investment activities and retains deposit-taking permissions. The Government envisages a memorandum of understanding being put in place between the Authorities for the application of relevant tools.

The Bank Insolvency Procedure (BIP) (as set out in Part 2 of the Banking Act 2009) has, as its first objective, the fast payout (or transfer) of Financial Services Compensation Scheme (FSCS) protected deposits. If an investment firm also has a deposit-taking business, then one option available to the Bank of England or the FSA would be for it to be placed in the BIP to achieve a fast payout for depositors.

In this case, the Government envisages that provisions will be added to the special administration regime to take on board the provisions of the BIP. The special administration regime for investment firms would therefore include an additional special administration objective equivalent to that set out in section 99(2) of the Banking Act 2009 that the administrator had to work with the FSCS so as to ensure that as soon as reasonably practicable, each eligible depositor had their relevant account either transferred to another institution or received compensation for it from the FSCS.

This would take place in the first few days of the administration but no estate or client assets would be involved in the payout. Therefore, the pursuit of this 'depositor payout' objective by the administrator could take place at the same time as the pursuit of the objective prioritising the return of client money and assets without interfering in it.

The administrator's actions in pursuit of this objective would be overseen by the Bank of England, the FSA and the FSCS in a role equivalent to their role as liquidation committee under the BIP with similar powers (see section 100, subsections (4) and (5), and section 101 subsections (2) - (6) of the Banking Act 2009). Once the administrator is of the opinion that the objective has been achieved (or achieved as far as it can be), then the Bank of England and the FSA would pass a resolution to that effect (equivalent to the BIP's full payment resolution) and the Authorities would stand down.

Full details as to these provisions are to be provided in the next consultation paper, expected in 2010, which will set out the text of draft regulations on the investment firm special administration regime.

Intra-day support

2.54 The LBIE insolvency has shown that strain on an investment firm's liquidity at the time of its failure could exacerbate its effects in three ways:

- it can be one of the factors forcing directors to file for insolvency without being able first to begin winding down positions in an orderly manner;
- there are likely to be limited, if any, resources within the legal entity to close out or settle open positions, neither for pre-insolvency resolution nor during the insolvency process; and

- administrators can face a shortage of resources to pay operational staff and vendors in administration, in order to ensure that they continue to provide services post-insolvency. The Government addresses this issue through the operational reserve proposed in Chapter 3.

2.55 As discussed in the May consultation paper[11], in the first few days after the failure of Lehman became apparent on 15 September 2008, JP Morgan and Citibank in the US provided Lehman Brothers Holding Inc (LBHI) and Lehman Brothers Inc (LBI) (the US parent of LBIE), with intra-day liquidity amounting to billions of dollars, under their respective clearing agreements with the entities.

2.56 Investment firms are likely to require substantial amounts of funding when closing out or settling the numerous open positions of the firm at the time of failure. Careful consideration will have to be given to the costs and benefits of such funding. The Government will explore obstacles to the provision of intra-day funding by third parties to investment firms in the UK immediately prior to, and following, the firm's insolvency. The Government will also consider whether changes to legislation are required to address this issue.

2.57 The Insolvency Service (IS), in its recent consultation *Encouraging Company Rescue*, considered measures intended to promote access to new finance for distressed businesses seeking to restructure their affairs. Based on responses to the consultation, the Government has decided that it will not, for the moment, be taking forward these proposals, but will continue to work with stakeholders to monitor the position going forward. Given the magnitude of the funding likely to be required for unwinding the business of an investment firm in an orderly manner, the Government welcomes views on whether there is a case for considering new financing provisions specifically for investment firms in the proposed special administration regime. Improved access to finance in those circumstances might allow administrators of a failed investment firm to use such funds to trade in order to close off risks and settle positions, potentially improving the returns for the estate.

2.58 However, firms should not expect the Government to use public funds to allow investment firms to continue trading during the pre- and post-insolvency resolution process. In addition to the risk of creating moral hazard, this could also give rise to State Aid issues. In general, the Government believes that the resolution plans proposed in Chapter 3 will contribute significantly to the orderly wind-down of the firm without imposing disproportionate costs on the public finances.

Question 9

Is there a case for considering provisions in the special administration regime for investment firms in relation to new financing? The Government also welcomes feedback on the potential legislative or other hurdles to an investment firm obtaining additional funding from third parties in the period immediately before insolvency to close out its positions. Are there other issues or options in relation to intra-day support that the Government might need to consider?

[11] Box 4B: Managed wind-down and resolution of Lehman Brothers Inc (LBI) and Lehman Brothers Holding Inc (LBHI).

Cost-benefit analysis - Question 10

The Government considers the costs to market participants of implementing the special administration regime, with provisions for special administration objectives, liability of insolvency professionals and directors, and possible legislative changes for intra-day support to be negligible.

Do you agree with the cost suggested in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

Other actions by the Authorities

2.59 The Authorities have an interest in ensuring the resolution of investment firms takes place effectively, with minimum disruption to market activity and financial stability. The Government proposes actions by the Authorities aimed at providing clarity around, and practical support for, the pre- and post-insolvency resolution of an investment firm.

Communication plans

2.60 Lessons from the LBIE administration suggest that in the first few days following insolvency, the market would have preferred quicker and more informative communication by the Authorities on their proposed handling of the LBIE insolvency. However, it must be recognised that there is a balance to be struck between the need for providing relevant information in a prompt manner in order to provide confidence to the market and maintaining confidentiality of certain types of information whose disclosure might otherwise precipitate further difficulties.

2.61 To reflect this, in the May consultation paper, the Government indicated commitments on effective communication by the Authorities, where they will plan for practical and coordinated action in the run up to, and period immediately following, an investment firm's insolvency. Consultation responses and stakeholder discussions suggest that the Authorities need to put in place established and coordinated communication channels for dealing with investment firm failure. The Authorities need to be seen to be taking a visible role prior to and following investment firm insolvency, particularly in the case of systemically important firms, in order to provide greater confidence to the market.

2.62 The Government is committed to developing effective communication plans that appropriately inform the market about the degree and nature of authority or regulatory involvement in the event of an investment firm insolvency. This information will set out the agency responsible for different issues emerging from the institution's administration. The Authorities already have in place procedures for market communication during crisis periods. Improved communication on investment firm resolution will be based around existing Tripartite contingency measures, such as the Financial Sector Continuity website, the FSA's own website or the Bank of England's Cross Market Business Continuity Group. This could be supplemented by a single portal for information on investment firm resolution within a dedicated part of the Tripartite website.

2.63 Improved communication could include wider assurances to the markets around the interaction of the Authorities and the administrators with infrastructure providers such as recognised clearing houses and exchanges, and international regulators where relevant. However, it must be recognised that it is not always appropriate to reveal the details of such engagement. Authorities could also provide additional information such as assurances around international coordination where cross-border firms are concerned, authority plans and timelines towards achieving effective resolution as well as guidance around how open trades are to be treated.

2.64 The Government remains open to suggestions on additional mechanisms and types of information that may be necessary to improve communication to the market and would welcome views on this.

Question 11

The Government would welcome views on the types of communications methods market participants would prefer and the type of information they would like to receive from the Authorities in case of an investment firm failure.

Cost-benefit analysis - Question 12

The Government considers the costs to market participants of a resource centre providing best practice guidance to administrators, and plans for coordinated market communication in the event of investment firm failure to be negligible, as these would require no market action.

Do you agree with the cost suggested in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

Resource centre for administrators

2.65 As discussed in Chapter 7, the Government proposes setting up a resource centre housed within an existing body, to provide practical support to administrators for risk management of the trading book and valuation of complex trading positions. The focus of the resource centre will primarily be on providing specialised risk management and valuation resources to support administrators in managing the trading book of the investment firm and its risk exposures, for the benefit of general creditors.

2.66 The Government proposes that the centre also houses general guidance on best practice for the administration of large, complex investment firms, drawing on lessons from previous insolvencies. The Authorities can provide administrators of an investment firm with immediate access to the resource centre and the administrators can draw on the guidance as and when needed. This will reduce the time required by the administrators at the beginning to set up systems and processes for the administration, enabling them to focus quickly on reconciliation of claims.

International issues

2.67 In Chapter 8, the Government highlights actions other key jurisdictions and international organisations are considering with respect to mitigating the failure of a systemically important financial firm.

2.68 The Government proposes that branches of international groups and other companies in the UK that may not be subject to the firm-level resolution proposals outlined in this paper could be required to disclose to customers that the UK's resolution regime for investment firms does not apply to them. These entities could also be given the option to opt into the regime, where there is no requirement on them to be wound up under their home state's law. There is a strong incentive for these entities to opt into the regime, given the broad international consensus that effective resolution arrangements need to be in place for cross-border financial firms.

2.69 The Government proposes to address informational issues for investment firms that are part of a cross-border group. An example of this would include the cross-guarantee of risks within the group and operational and legal links between various parts of the group. Relevant information would be provided by BIPs approved by the UK regulator, as discussed in Chapter 3. In addition, cross-border cooperation is important in order to support firm-level actions for continuity of service from suppliers located in other jurisdictions, as discussed in Chapter 3.

Question 13

Do you agree with the Government's proposal for international entities not subject to these proposals to be able to 'opt in' to the firm-level resolution regime?

Question 14

Are there any other specific issues in relation to cross-border investment firms, not considered here or in Chapter 8, that need to be addressed?

Other initiatives under consideration

2.70 The Government is committed to investigating all aspects of investment firm resolution in order to enable the managed wind-down of a failing firm with minimum disruption to market participants and financial stability. The Government believes that the package of measures proposed in Chapters 2 and 3, along with proposals to deal with specific client, counterparty and creditor issues in Chapters 4 to 7, will go a long way to support the Government's objectives in addressing investment firm failure.

2.71 Some commentators have noted that the UK could benefit from more extensive powers around investment firm insolvency, including a special resolution regime (SRR) along the lines of the regime established for deposit-taking institutions under the Banking Act 2009. The Government is not actively taking forward proposals in this area at present, but will continue to consider options around SRR-type tools as appropriate, in conjunction with the Bank of England and industry experts.

Question 15

The Government welcomes views on the extent to which the package of measures proposed in Chapters 2 and 3 will contribute to achieving the effective resolution of investment firms. Do you believe there is a case for the measures to be further enhanced by a special resolution regime for investment firms?

Summary of proposals

This chapter sets out a number of cross-cutting proposals that aim to enable effective resolution of a failed investment firm, both at the pre- and post-insolvency stages. The key proposals discussed in this chapter relate to legislative changes and actions by the Authorities that complement regulated market actions discussed in Chapter 3, and include:

- Creation of a special administration regime for investment firms, incorporating special administration objectives that are based on a principle of precedence, prioritising certain activities such as the return of client assets over others. The objectives would maintain ordinary creditor rankings and would not seek to create preference.
- Introduction of a special defence against liability for administrators if they can satisfy the court that they acted according to the special administration objectives for investment firms.
- Introduction of a special defence against liability for directors of investment firms, if they can satisfy the court that they acted according to the investment firm resolution plans discussed in the next chapter, in consultation with the FSA.
- Exploring obstacles to the provision of funding by third parties to investment firms in the UK immediately prior to, and following, the firm's insolvency.
- Planning for coordinated communication by the Authorities at the time of an investment firm's insolvency, to provide greater confidence to the market on the resolution process.
- Establishing a resource centre for insolvency practitioners, providing best practice guidance on the administration of large, complex investment firms.
- Considering areas where international cooperation is required and considering whether there is a strong case for further legislative measures, such as a special resolution regime for investment firms.

3 Requiring firms to manage for failure

3.1 In Chapter 2, the Government proposes legislative changes, including a special administration regime, to address the difficulties inherent in resolving large and complex investment firms. These proposals are designed to aid administrators in winding up a firm effectively and are at the centre of actions that the Authorities are taking to manage investment firm failure. In addition, the Government believes that firms themselves must be required to play a leading role in preparing for, and managing, their own resolution.

3.2 In this chapter, the Government proposes a package of policies, which investment firms would be required to implement under new FSA regulations. These policies would build upon the steps laid out in Chapter 2, by requiring firms to take action in two broad areas;

- first, to allow for a managed wind-down of the firm such that its entry into administration is manageable and orderly, avoiding the disruption involved in a sudden failure where no mitigating steps have been taken; and
- second, to take steps to provide resources which will aid administrators once the firm enters into administration.

3.3 The main policy options that the Government is consulting on include regulatory requirements for firms to:

- appoint a business resolution officer to implement their resolution actions;
- produce investment firm resolution plans to address the particular challenges arising from the complexity of their business;
- set up a business information pack for use by administrators;
- put in place continuity of service arrangements for business critical staff and suppliers post-insolvency; and
- maintain an operational reserve, for administrators to be able to pay key staff and suppliers post-insolvency.

The role and responsibilities of directors

3.4 As noted above, responsibility for the implementation of the proposals outlined in this chapter would lie with investment firms themselves. The Government expects firms to make adequate preparations for an orderly resolution of their affairs in the event of failure, just as they have in place business continuity measures to prepare for natural disasters, technological failure and other disruptions. The responsibility for taking these steps will lie with the directors of that part of the investment firm regulated or authorised in the UK. The Government believes that the UK directors must play the leading role in preparing for and managing the resolution of the UK legal entity.[12]

[12] Where the group is using a subsidiary rather than an EEA branch.

3.5 The Government recognises that major investment firms are international in nature, and that functioning along operational lines can provide efficiency and cost savings. It believes however that directors must continue to act in recognition of their legal and fiduciary responsibility towards affected parties, including clients, creditors and counterparties, at a legal entity level. Directors need to ensure that the UK firm can be resolved effectively without imposing disproportionate costs on affected parties, or on markets or the exchequer.

3.6 To formalise these responsibilities, the requirements for firms proposed in this chapter would be mandated through FSA regulation and supervision. In addition to this consultation, any new regulatory rules would be subject to full consultation and cost-benefit analysis prior to introduction by the FSA, consistent with the usual procedure set out in the Financial Services and Markets Act 2000 (FSMA).

3.7 Consistent with this approach, the Government is already taking forward work to ensure effective recovery and resolution of firms. The Financial Services Bill will place a statutory duty on the FSA to require firms to produce recovery and resolution plans (RRPs), to be applied to a range of institutions. This chapter describes a model (based on input from the Government's Investment Banking Advisory Panel) for the possible application of the resolution component of RRPs to investment firms.

3.8 In addition, the Government is of the view that the challenges surrounding the resolution of major investment firms are sufficiently complex as to require the application of a broader range of policy tools. This chapter therefore sets out a detailed package of policy proposals, consisting of actions which firms may be required to implement in addition to resolution plans.

3.9 The proposals in this chapter centre on the creation of a new role for a business resolution officer (BRO), a board-level officer of the firm to whom the board may delegate responsibility for delivering and implementing the firm's resolution actions. Table 3A lists the firm-level resolution options considered in this chapter, for which the BRO will be responsible, in the context of the overall resolution actions described in Chapters 2 and 3 of this paper.

Table 3.A: Managing the failure of investment firms – the resolution process

Actions by Authorities (Chapter 2)	**Entity-level actions (Chapter 3)**
Special administration regime Special administration objectives Administrators' liability Directors' liability: freedom & responsibility Removing legal barriers to provision of intra-day support by the market Other actions Communication plans Resource centre for administrators Dealing with cross-border firms	Actions to be outlined in FSA regulations Business resolution officers Investment firm resolution plans Business information packs Continuity of service arrangements – staff and suppliers Operational reserve

3.10 As indicated above, any proposed regulatory changes will be for the FSA to consider and, if necessary, take forward by way of consultation and cost-benefit analysis. The remaining sections of this chapter deal in turn with each of the proposals in Table 3.A.[13]

[13] The proposals in this chapter should be seen as specific to investment firms, and it should not be assumed that they would be applied to other types of firms.

Business resolution officers

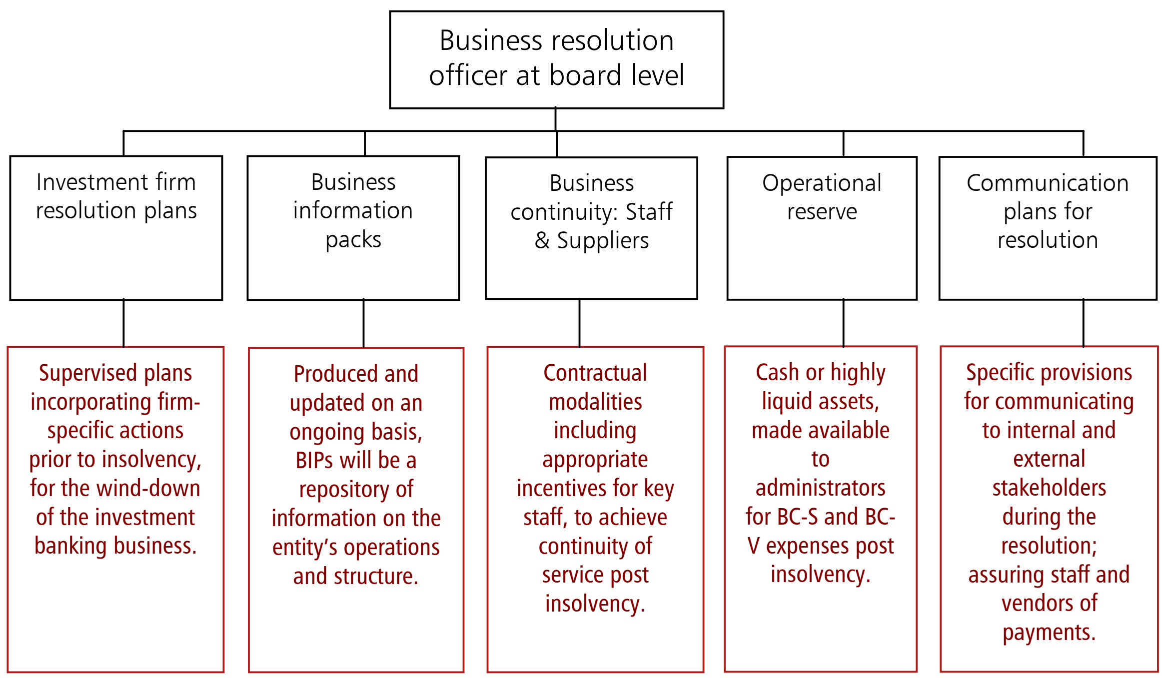
3.11 As indicated above, the Government is clear that the officers of the board of the UK legal entity within an investment firm must take seriously their responsibility towards those parties who may be affected by the failure of that entity. An important part of this duty is to ensure that they prepare and implement plans for an orderly and effective resolution of the firm at the time of failure.

3.12 The size and complexity of investment banking activity pose substantial difficulties for investment firm resolution both before, during and subsequent to any failure. One way to mitigate these difficulties would be to have an individual at board level, to whom the board's collective responsibility for resolution could be delegated, and who would be responsible for coordinating and overseeing the implementation of the resolution process.

3.13 The Government proposes the creation of a new role within an investment firm's corporate governance structure, that of a business resolution officer (BRO), who will play a prominent role in directing the firm's resolution actions. The Government envisages that the functions of the BRO would be taken on by an existing board-level company officer (for example, the Chief Operating Officer), as resolution actions are unlikely to be required on a day-to-day basis.

3.14 As Chart 3A illustrates, the BRO would be central to managing effective resolution at the entity-level and would be responsible for ensuring that the firm can be wound down effectively, both in the run up to, and following, insolvency.

Chart 3.A: Overview of policy tools discussed in this chapter



Responsibilities

3.15 The Government proposes that the BRO would have ongoing responsibilities under both business-as-usual and distress situations. At both stages, these responsibilities would include supporting the FSA's supervision of recovery and resolution planning – whether this be drawing up plans during the business-as-usual phase, or actually implementing the actions contained in the plans during a live stress or failure scenario. Table 3B outlines in further detail the proposed responsibilities of the BRO with respect to each of the resolution policies discussed in this chapter.

3.16 In general, the Government considers that a person holding this position would be required to ensure under business-as-usual conditions that: (a) they are available as a key point of contact for the Authorities and auditors with respect to resolution actions; (b) the firm is satisfying regulatory requirements with respect to these; and (c) they report compliance to the Authorities on a timely basis.

3.17 In a distress situation, the BRO would be required to ensure that the board: (a) communicates the directors' intentions to the Authorities; (b) implements effectively the investment firm resolution plans under supervision by the Authorities; and (c) communicates to internal and external stakeholders as required.

Table 3B: Proposed board responsibilities delegated to the BRO, with respect to entity-level resolution policies

Policy action	Business-as-usual responsibilities	Distress situation responsibilities
Investment firm resolution plans (paragraphs 3.20 to 3.27)	Being the key point of contact at the firm with whom the regulator will work to ensure that resolution plans are initially drawn up in accordance with FSA guidelines. Ensuring that these are updated and audited regularly, are on the agenda for board meetings on a regular basis and are internalised in the firm's corporate governance and business continuity procedures.	Overseeing the effective implementation of the resolution plans. Ensuring that the board clearly indicates to the authorities the directors' intentions as to resolution, for example, whether the directors look to negotiate a buy-out of some or all of the business, or whether the intentions are for a managed wind-down leading to insolvency.
Business information packs (paragraphs 3.28 to 3.41)	Ensuring that BIPs are established to the satisfaction of supervisors, updated and audited regularly.	Ensuring that BIPs are supplemented with information on trading positions and liabilities (as discussed in the BIPs section of this chapter), and are readily available to administrators post insolvency.
Business continuity measure – Staff (paragraphs 3.42 to 3.58)	Ensuring that key staff are identified and suitable contracts and compensation incentives/ disincentives are in place. Ensuring these are identified in the BIP and updated in case of changes.	Acting in a leadership role to encourage retention of key staff.
Business continuity measure – Suppliers (paragraphs 3.59 to 3.69)	Ensuring that appropriate (insolvency-proof) contracts with suppliers are in place, that these are identified in the BIPs and updated in case of changes.	Serving as an interlocutor between administrators and suppliers of key services in case of administration.
Operational reserve (paragraphs 3.70 to 3.77)	Ensuring that reserve is set aside, and that information with respect to operational funding is recorded in the BIPs. Ensuring that the firm complies with these requirements and being in charge of producing a report for the FSA.	Providing assistance to administrators, if required, in accessing the requisite funding in case of administration.

Policy action	Business-as-usual responsibilities	Distress situation responsibilities
Communication plans	Ensuring effective internal and external communication.	In addition to specific duties for each of the above, the BRO could be required to include specific provisions in the firm's communications plans for communicating to internal and external stakeholders during the resolution period. This would include assuring staff and suppliers of their compensation.

Question 16

Do you have views on the coverage or detail of the BRO's responsibilities as outlined here? Are these consistent or compatible with existing templates for the corporate governance structure of firms?

Appointment of business resolution officers

3.18 As discussed above, the BRO will play a key role in discharging the specific duties of the Board related to resolution actions. Therefore, the Government considers there to be a strong case for the BRO to be a supervised function and will consider asking the FSA to include the BRO as a controlled function for the purposes of the Approved Persons regime under FSMA. However, the Government does not envisage these responsibilities as entailing legal liability distinct from those of an Approved Person and/or officer of the board.

3.19 The BRO and the BRO's associated responsibilities will have to be part of the firm's required corporate governance standards. They will ensure that the entity-level responsibility of directors is actively incorporated in management decisions, for example, through regular discussion of resolution measures at board meetings. One way in which the FSA could monitor the firm's investment firm resolution plan and BIP could be through requiring the BRO to prepare reports regularly; for example, to update the FSA on any changes to resolution provisions.

Question 17

Do you agree with the basic policy of establishing a role for business resolution officers in investment firms and do you believe that this is an effective way for the FSA to ensure that the firm implements resolution actions effectively?

Question 18

What are your views on the nature of appointment of the BRO? Do you agree with the Government's suggested approach for implementing this policy, for example, the role being additional to a board member's pre-existing duties and part of the FSA's Approved Persons regime?

Cost-benefit analysis - Question 19

Discussions with stakeholders indicate that the additional responsibilities of a board-level officer as a BRO would require 10-20 per cent of their time on an annual basis or £100,000 to £200,000 per annum.

Do you agree with the cost suggested in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

Investment firm resolution plans

3.20 As indicated above, the Government is legislating, through the Financial Services Bill, to create a statutory duty for the FSA to require firms to produce RRPs. More detail is laid out in Box 3.A, below. In developing these requirements the FSA will focus on deposit-taking firms subject to the special resolution regime in the Banking Act 2009. The Government recognises that firms may carry out multiple different types of activity (for example deposit-takers may conduct investment business) and that RRPs for firms conducting multiple activities will need to reflect this. This section details a possible model for resolution plans specifically applying to firms whose primary focus is carrying out investment business.[14]

[14] This paper does not deal with the recovery plan element of RRPs for investment firms. Recovery plans could however be covered in FSA work on RRPs for investment firms.

Box 3.A: Financial Services Bill provisions regarding the introduction of RRPs

The Financial Services Bill incorporates a number of key provisions regarding the introduction of Recovery and Resolution Plans (RRPs). RRPs will generally be a tool for both reducing the likelihood that firms fail – by requiring them to have in place a practical recovery plan to help them get out of difficulty during a stress scenario – and for reducing the impact of a firm's failure.

Both components of the RRP will become a core part of the supervisory toolkit for dealing with financial firms. The resolution element, in particular, will be important for ensuring that the Authorities can allow large, and potentially systemic, firms to fail thereby mitigating the problems with moral hazard which the financial crisis has revealed, and contributing to the wider efficiency and stability of the financial system.

The Financial Services Bill will:

- place a duty on the FSA to make rules requiring authorised persons of a specified description, to produce RRPs. RRPs will require firms to establish credible recovery plans, and to facilitate the application of resolution tools by the Authorities, should firms fail or circumstances arise that make it likely that they (or part of their business) will fail. The FSA will consult on the detailed rules on RRPs in the normal manner, and this will include a full cost-benefit analysis;
- specify that the FSA must make rules for those authorised persons subject to Part 1 of the Banking Act 2009 (deposit-taking firms) and provides an order-making power for the Treasury to stipulate to the FSA the dates by which RRP rules must be in place for a particular category of authorised persons. The Treasury must consult the FSA before making such an order;
- require the FSA to consult the Bank of England and HM Treasury before preparing draft rules for both recovery and resolution plans in respect of deposit-taking firms, and to have regard to any relevant international standards on RRPs. Opportunities for regulatory arbitrage and detrimental effects for the UK's competitiveness will therefore be minimised; and
- require the FSA to consider whether all RRPs are satisfactory. The FSA must consult the Bank of England and HM Treasury on RRPs for deposit-taking firms. Finally, the Bill gives the FSA additional enforcement powers related to the collection of information in relation to RRPs.

3.21 The FSA, in its *Turner Review Conference Discussion Paper* published in October 2009, has set out a high-level timeline for work on the overall framework for RRPs. It will be conducting a pilot exercise with a small number of major UK banking groups, to be completed by mid 2010. The FSA will determine the requirements to apply to different regulated sectors, including investment firms, and will be taking this work forward under the statutory duty to be imposed under the Financial Services Bill. The Government is of the view that investment firms should be a primary area of the FSA's work.

3.22 Given the systemic importance of ensuring effective resolution of investment firms, the Government has been working with the Advisory Panel to develop a high-level model of how investment firm resolution plans might be constituted.

3.23 Plans will need to be tailored to the specific requirements of an investment firm resolution, including any changes to the administration regime which result from this consultation. They need to ensure that an investment firm is able to:

- deal with client money and assets and counterparty positions effectively before any administration proceedings are required, for example through sale of business or complete wind-down; and
- organise its business and start to reconcile positions, so that in the event of administration, administrators are able to resolve effectively client money and assets and counterparty positions with minimum disruption to the markets.

3.24 In addition, given that the actions to be taken under the resolution arrangements proposed in this document fall short of formal legal powers for the Authorities to intervene through a resolution regime, the actions included in an investment firm-focused resolution plan will be much more directed at actions to be taken by the firm itself in preparing for administration than would be the case with RRPs for deposit takers.

3.25 Based on discussions with the Investment Banking Advisory Panel, the Government sets out a model for an investment firm resolution plan in Boxes 3.B and 3.C below, and seeks feedback on the options presented, which it will consider with the FSA. Final proposals for RRPs for investment firms, as eventually developed by the FSA, would include additional elements, including a well-developed recovery plan component.

3.26 The Government envisages that the design of investment firm resolution plans could include two components:

- agreed principles and types of actions for a period of two or three weeks prior to failure (Phase I), during which the firm would carry out resolution actions that are internal, rather than market-facing. These could be based broadly on principles of simplification, rationalisation and reconciliation; and
- specific, pre-planned market-facing actions for a wind-down period of two to three days (Phase II or the 'pre-insolvency corridor') when it becomes clear that the directors or Authorities will have to initiate administration proceedings.

3.27 The types of actions that could be undertaken in these two phases are outlined in more detail in Boxes 3.B and 3.C.

Box 3.B: Initial thinking on investment firm resolution plans; Phase I (internal) actions

In order to enable an orderly wind-down of the firm's business in the period leading up to insolvency, firms would carry out resolution actions that are not market-facing but internal, as proposed below. Internal actions in this phase could focus on actions to assist a managed wind-down and could be based broadly on principles of simplification, rationalisation and reconciliation. The types of actions following these principles could relate to:

Client assets, for example:

- limiting the rehypothecation of client assets; and
- ensuring that during the period of resolution plan implementation, client positions are reconciled on a daily basis, as proposed in Chapter 4;

Counterparty positions, for example:

- not taking on additional obligations in the money markets where there are no prior commitments (while continuing with any ongoing money market obligations or usual roll-over of positions, so as not to send negative market signals); and
- working out the firm's positions on trades with counterparties, including net exposures on a more regular basis;

Business operations for example:

- freezing new staff hires and renewal of temporary contracts;
- internal actions to simplify intra-group trading and payment arrangements and to ring-fence parts of the business from exposures to more risky business areas;
- during the period of resolution plan implementation, identifying assets/business units for sale and their interdependencies with other parts of the business, identifying potential buyers of the same, and if possible negotiating on a confidential basis with potential buyers (the firm could continue to implement the internal investment firm resolution plan actions until the buy-out or merger is made legally binding); and
- demonstrating the ability to supplement the regular BIPs (as discussed in the section on BIPs) with additional information on assets and liabilities, trading positions etc. so as to provide relevant information for potential buyers when required (similar to 'data rooms' currently used for mergers and acquisitions) or for administrators in the event of insolvency.

The Government recognises that the firm's management should be taking some of these actions in a distress scenario in any case, without the existence of resolution plans. However, standardising and formalising these practices would provide confidence to the Authorities and the market that plans are in place that would contribute to the investment firm's effective resolution. It is anticipated that the FSA could ask for firms to commence these steps when it believes a failure is likely but not inevitable, ideally some weeks before the firm's ultimate entry into administration.

Box 3.C: Initial thinking on investment firm resolution plans; Phase II (market-facing) actions

Following internal actions outlined in Box 3.B, conditions could worsen, a market announcement may have to be made, and the Directors and/or the Authorities may determine that insolvency proceedings are likely to be required. In this case, the firm could implement specific market-facing actions in the pre-insolvency corridor mentioned above. The firm could be required to specify in the resolution plan operational processes and steps for such market-facing actions, including steps to:

- begin reconciling and returning client assets and monies;
- begin novating, terminating or settling open positions with counterparties;
- stop taking on new risks or new business and to reduce market exposures;
- start disposing of certain fixed assets if required, such as any gold reserves;
- complete sale of business units where negotiations have taken place already (see 'Business operations' in the Box 3C above); and
- communicate relevant information to the market, including market infrastructure providers, and the firm's staff and essential service providers. For example, information on client assets and monies, counterparty positions, availability of funding to pay staff, and extent of engagement with the Authorities.

The pre-specification of these actions in the resolution plan would have to be limited to demonstrating that the firm has in place the processes, systems and decision-making plans with respect to each of the actions to enable it to act should any of the actions be required, given the circumstances. Again, whether it would be in the best interests of a managed wind-down for the firm to actually implement any of these actions under the specific circumstances would be for the FSA to decide in consultation with the firm's management.

Question 20

Do you agree that investment firm resolution plans can consist of internal actions followed by market-facing actions as proposed above?

Question 21

What are the obstacles to implementing investment firm resolution plans as suggested in this document? What policies could the Government consider to address these, if any?

Cost-benefit analysis - Question 22

Initial discussions with stakeholders indicate that for the prime brokerage business, initial costs of setting up investment firm resolution plans could be about £1-£3 million, with a team of about ten people from different parts of the business working on them. The prime brokerage business may incur an additional £0.5-£1 million per year for continually updating the resolution plans, with a team of three people working on them.

Stakeholders have suggested that costs for the entire investment banking business, including prime brokerage, would be approximately five times the costs for the prime brokerage business mentioned above; £5-15 million one-off costs, and £2.5-£5 million annual costs.

There may also be ongoing benefits to the investment banking business from having in place continually updated resolution plans. These may include, for example, increased operational efficiency from identification of interdependencies between business units. However, these are not taken into account here, as it would be challenging to estimate the effect of resolution plans separate from that of other factors.

These costs will ultimately depend on the final proposals put forward by the FSA. As discussed above, the FSA will be conducting a full cost-benefit analysis of its proposals.

Based on the proposals for resolution plans outlined here, do you agree with the suggested costs for the prime brokerage business?

Question 23

What resources do you expect the entire investment banking business of the firm to spend on resolution plan implementation? Costs would include those related to: (a) designing and setting up resolution plans in collaboration with the FSA; (b) the ongoing audit and update of resolution plans and their inclusion in the firm's corporate governance activities; and (c) the additional resources required to implement resolution plans in a distress situation, if any.

Business information packs

3.28 In its May consultation paper, the Government indicated that it would be helpful if investment firms, particularly those that were systemically important, were required to keep a business information pack (BIP) that could be made available to administrators on day one to:

- assist them to come to grips rapidly with the business; and
- to facilitate the settlement of trades or the return of client assets in a timely matter.

3.29 The Government envisages a BIP as forming a contemporaneous and accurate repository of information on the investment firm's business. In the event of insolvency, this repository will provide administrators with relevant information that will support them in securing continuity of business operations to facilitate the orderly wind-down of the failed firm. A successful and proportionate information pack should also allow the Authorities to better understand the risks to client funds and to be better prepared in communicating with the market when an investment firm fails. These will get administrators up to speed enabling them to act quickly, without needing to spend a substantial amount of time and resources.

3.30 As discussed in Chapter 1, the firm's directors have a responsibility towards clients, counterparties and other stakeholders of the legal entity they manage. One of the important aspects of the BIP in the Government's view is the availability of business and financial information on a legal entity basis.

3.31 The previous section describes the role of the investment firm resolution plan and how it differs from the BIP. The BIP, although constructed pre-insolvency is to be used by the administrator once the investment firm is in administration, while the investment firm resolution plan is primarily a pre-insolvency measure.

3.32 The Government believes that in addition to systemically important investment firms, firms with client assets and monies may also fall within the scope of this proposal, though this will be a matter for the FSA to consider. The Government considers that it is important for BIPs to be proportionate, and tailor-made to reflect the risks, size and specialist activities associated with the investment firm that is required to produce them.

Contents of business information packs

3.33 The composition of BIPs will aim to reflect any existing regulatory requirements to produce and report certain information, such as may be required by the FSA. These initial proposals may be amended to reflect ongoing consultation by the Government and the FSA, as well as any international developments.

3.34 The Government considers that the information maintained by the firm for its usual contingency planning and regulatory requirements could be redesigned or reinterpreted for inclusion in the BIP, which would be proportionate in detail to the business it represents. Whatever the form of the BIP, it is important for the information to be presented in a manner that is understood by an external party (such as an administrator), with no previous information about the firm's business, without requiring constant support in interpreting its technical aspects.

Proposed types of information to be included in business information packs

3.35 The Government recognises that all investment firms are different, and that a one-size-fits-all approach to the development of business information packs is unlikely to be fully effective; instead it will be appropriate for the FSA to allow the BRO some discretion as to the types of information included in the BIP for their specific firm. There are however a substantial number of items that the Government believes should be included, in some form or another, in all investment firm BIPs approved by the FSA, as described in Boxes 3.D to 3.I below.

Box 3.D: Business structure

Information that maps in detail how the firm is structured in terms of the number and location of subsidiaries and branches, and explains the way the individual businesses interact or interrelate with each other operationally and legally.

This will include details on:

- organogram of group structure, including intra-group dependencies;
- location of companies, detailing both UK incorporated and foreign subsidiaries;
- operational, financial and legal links between entities;
- further details on non-UK based entities in cases where there is significant cross border investment business; and
- origin of business i.e. where, in terms of the structure and location, transactions within the group originate from.

Box 3.E: Business information & risk management

Information that will allow outside parties to understand quickly how a firm executes its business on a day-to-day basis and how it manages risk.

This will include details on:

- the location of and methods used to maintain and record daily transactions;
- how daily reporting is utilised for monitoring exposure and risk;
- account numbers with settlement banks and custodians; and
- specific risk management methods including up-to-date details on where the firm is exposed significantly in terms of products, sectors or counterparties.

Box 3.F: Business strategy and decision-making

This will be information that supplements information on the investment firm's structural organisation by showing how business and risk decisions are made, either centrally or locally. This will be useful particularly in the case of larger, more complex firms, where responsibility for decision-making processes may involve several subsidiaries or branches, or where decisions made by the UK entity may have implications for operations at a global level.

Decision trees could therefore be included to cover the following areas:

- breakdown of assets, liabilities, revenue and profits along legal entity, business and geographic lines;
- regulatory permissions and business entities carrying them out;
- details of operations of key legal entities;
- details of national/international markets and financial systems where the firm operates;
- products such as equities, loans or corporate investment;
- business areas such as commodities, private banking or custodian business;
- key Authorities and market infrastructure membership; for example, trading, clearing, settlement systems used; and
- business time zones and crucial cut-off times.

Box 3.G: Personnel

This should provide external parties with a full list of all the investment firm's key personnel, including description of key staff contracts (discussed in the next section), in order to assess the firm's ability to continue to operate post insolvency. As well as staff contracts and an organogram of senior management, this could include information on those responsible for key areas including:

- business in the UK and other jurisdictions;
- group/local risk management;
- compliance and tax;
- all products and business sectors; and
- business continuity and business resolution measures.

Box 3.H: Key operational costs & logistical information

On arriving at the premises of the firm in administration, administrators will need to establish quickly how the day-to-day operations of the firm are funded, including the payment of wages. Similarly, they will need to know other details about the day-to-day infrastructural operations, including its key outsourcing contracts and key suppliers. The Government is of the view that in addition to the BIP, investment firms should have in place 'insolvency-proof' contractual arrangements with providers of IT and other essential services, as described in the next section.

Therefore, the Government expects a BIP to detail the following:

- funding source of all operational and running costs including salaries i.e. an 'operational reserve' as described further below;
- key supplier contracts;
- outsourcing contracts and arrangements;
- practical building operations/infrastructure arrangements; and
- IT infrastructure contracts, outsourcing arrangements and software licences.

Box 3.I: Funding & liquidity

In some cases, investment firms may adopt risk-shifting mechanisms across different entities in their respective groups. The firm may have guarantees and support processes in place, if one part of the group requires financial assistance to meet pressures over the short to medium term. It would be vital for outside parties to be aware of this during the course of an insolvency and, therefore, the following information could be included in the BIP:

- full details of all support and guarantee packages put in place between parts of the firm or group; and
- alternative funding sources e.g. external sources.

Ensuring effective implementation

3.36 The Government expects the BIP to be a living document or a series of reports subject to continuous updating rather than a static or infrequently revised record. It would need to reflect the changing nature of the circumstances and risks associated with a large and complex investment business.

3.37 As set out in the discussion of BRO responsibilities earlier in this chapter, the Government sees the compilation and management of the BIP and its final sign-off within the firm as being embedded in the role and responsibilities of the BRO. The Government proposes for the BRO to be required to ensure that the BIP is kept up to date and audited regularly.

3.38 The FSA will need to assess the adequacy of the BIPs prepared by the firm. Based on discussions with stakeholders, the Government proposes that BIPs could be audited through regular annual company audits, as part of an existing audit regime approved by the FSA. The FSA could also consider a concerted evaluation and stress testing of the BIP at the conception stage, followed by an agreed regular audit process over the longer term, depending on the size and complexity of the firm.

Access to and format of business information packs

3.39 In order to speed up the resolution process, the Government expects administrators and Authorities to have full access to the BIP at or around the time of insolvency. It understands the concerns of investment firms about allowing third parties access to commercially sensitive information.

3.40 The Government proposes that in the run up to insolvency, for example as part of the resolution plan actions discussed earlier, the information in the BIP could be supplemented to include the latest position of the investment firm with respect to its trading activity and financial position. This would be useful not only for administrators in case of insolvency, but could also be used by the firm in negotiating a buy-out or merger as part of its resolution plan. For example, this could include information on valuations of trading positions, detailed liquidity and exposure positions on legal entity and whole group basis and asset quality.

3.41 The format in which BIPs are stored would have to reflect information requirements, the firm's information technology capabilities, as well as the need to manage complex and rapidly changing corporate information. Restricted access (virtual) data rooms, for example, as currently used by firms for acquisitions, could be adapted for maintaining key BIP information in an accessible form for the Authorities and administrators. Varying degrees of security clearance and access could be provided as a potential insolvency event develops.

Question 24

Do you agree that business information packs will be useful to administrators and will fulfil the Government's objectives for a managed wind-down of investment firms?

Cost-benefit analysis - Question 25

Initial discussions with stakeholders indicate that for the prime brokerage business, initial costs of setting up BIPs would be similar to those of investment firm resolution plans, at about £1-£3 million, with a team of about ten people from different parts of the business working on them. The prime brokerage business is likely to incur an additional £0.5-£1 million per year for continually updating the BIPs, with a team of three people working on them.

Stakeholders have suggested that costs for the entire investment banking business, including prime brokerage, would be approximately five times the costs for the prime brokerage business mentioned above; £5-15 million one-off costs, and £2.5-£5 million annual costs.

As in the case of resolution plans, there may be ongoing benefits to the investment banking business from having in place continually updated BIPs, but these are not included here.

Based on the proposals for BIPs outlined here, do you agree with the suggested costs for the prime brokerage business?

Question 26

What resources do you expect the entire investment banking business to spend on BIPs' implementation? Costs would include those related to: (a) the designing and setting up of BIPs in collaboration with the FSA; (b) the ongoing audit and update of BIPs and their inclusion in the firm's corporate governance activities; and (c) the additional resources required to supplement the BIPs in a distress situation.

Continuity of service

3.42 Major investment firms typically operate interrelated global infrastructure, in particular having integrated IT systems and services and human resources. Their trading, financing and other activities depend heavily on appropriate applications and skilled resources related to counterparty positions, client assets, structured securities and collateral.

3.43 In the May consultation paper, the Government outlined practical difficulties that administrators of such firms are likely to face in terms of access to business critical services and the continued employment of key staff in the event of the firm's failure. These difficulties may be compounded due to the location of IT and data systems in other jurisdictions, as illustrated by the implications of the collapse of Lehman Brothers' IT function, described in the May consultation paper.

3.44 Policies that ensure the continuity of key services post-insolvency are an important part of efforts to ensure a managed wind-down. Even if BIPs were in place, the administration process could still be drawn out and disorderly if administrators do not have access to or control of essential services and systems or are unable to retain key staff.

3.45 The Government outlines below the firm's responsibility to ensure continuity of service from the firm's key staff and suppliers in the event of its failure. In addition, as noted in Chapter 8, the Government would welcome any initiatives arising from the technical advice provided by the Committee of European Securities Regulators for the review of the Markets in Financial Instruments Directive (MiFID) that addressed issues raised in this paper over the continuity of cross border services.

3.46 The mechanism proposed below, put in place by firms under business-as-usual operations, would provide practical support to administrators. The Government proposes for such arrangements to be in place for a period of ninety days, which would provide administrators with sufficient time to effect a transfer of knowledge or to make any alternative service provision arrangements.

3.47 For administrators to be able to make use of this provision, the Government proposes requiring firms to maintain adequate operational funding to pay the key staff and service providers. Firm-level action to ensure the availability of such operational funding post-insolvency is proposed in the next section. Also, the BRO would have to coordinate communication to staff and suppliers, in the event of insolvency, regarding payment for their services.

Staff contracts

3.48 To enable an orderly resolution process it is important to have an effective transition of the knowledge base prior to insolvency to a new one under administration. Administrators need to retain some staff from the investment firm after the initiation of administration. The presence of key senior officers would assist the administrators with managing the estate. Essential operational staff with knowledge of the firm's business critical infrastructure and operations would be able to work with administrators so that they are able to come to terms quickly with the operation of the business.

3.49 Under current insolvency law, administrators have up to 14 days to decide whether or not to adopt staff contracts (along with provisions such as pension rights) and retain employees of the failed firm. However, in practice, it is likely that key staff will take up employment elsewhere, if possible, immediately upon the firm's insolvency. Even if administrators are able to retain some staff, there is a risk that there are inadequate incentives for such staff to be productive and to engage effectively with the administrators.

3.50 The Government believes that regulated market action that ensures key staff are incentivised to remain in post for a specific period following the firm's failure is likely to be more effective than making legislative changes. The Government has asked the FSA to consider requiring firms to have in place staff contracts that achieve these objectives, as part of their overall regulated resolution actions.

3.51 In particular, the Government believes that key staff contracts should include a 90-day notice period, to be legally valid even when the firm enters administration, provided key staff are paid for their services. Firms could apply this provision under existing employment law. It is common for employment contracts to have notice periods ranging from one to three months. Furthermore, this provision is similar to provisions currently used under employment law such as, for example, rules around restraint of trade and 'gardening leave'.

3.52 In addition, the Government proposes that the firm should be required to include in the contracts a package of incentives and disincentives. This would serve to reduce the risk of staff ‘walking’ without complying with the notice period. Firms could choose to apply any combination of incentives and disincentives, after negotiating with key staff, so long as they are able to demonstrate to the FSA that any such package is designed with a view to retaining staff and ensuring they perform effectively under administration.

Box 3.J: Incentives and disincentives to retain employees

To retain key employees post-insolvency, the Government proposes that firms should be required to have in place contracts for key staff that include, in varying combinations:

Incentives: such as possibility of varying remuneration to individuals depending on performance at various stages of the process; recognition of the role of key staff under business-as-usual, which might provide reputational incentives for such staff to continue post insolvency; and

Disincentives: such as clawback of remuneration if performance is found to be unsatisfactory (through appropriate and fair performance review processes for the administration process); carefully drafted restraint of trade provisions in contracts etc.

Question 27

The Government would welcome views on what incentives and disincentives are likely to be effective and whether there are any concerns with the ones suggested above.

3.53 As discussed above, the Government is of the view that these provisions should be applied to ‘key staff’ that the firm identifies within its investment banking business i.e. a certain number of employees whose expertise and knowledge in specific business areas are critical for the continued operation of the business under administration. In determining and agreeing upon the relevant staff, the firm could take into account: (a) the firm’s existing business model; and (b) the objectives of effective resolution as set out in this paper.

3.54 The firm would then have to negotiate appropriate and reasonable contracts with such staff, taking into account existing employment laws, the degree of importance of staff functions and existing remuneration packages. The Government considers that the BRO (discussed above) would be responsible for ensuring that the list of key staff and a description of relevant contracts are recorded in the BIP and updated as required.

3.55 It is also important to ensure that some trusted management structure remains in place following administration. Investment firms tend to be organised on the basis of strong team culture and employees look to senior officers within the team for effective leadership. To ensure employees are motivated to work effectively, the Government believes that administrators need to retain some part of this senior management structure.

3.56 The Government is of the view that in the first week following the initiation of administration, administrators would need to retain most of the middle and back office staff. This would support the continued operation of data and other systems, the clearing and settlement of open positions and client asset reconciliation; the number of front office staff could be reduced immediately. Correspondingly, administrators would need sufficient funds for comparatively more staff in the first weeks.

Box 3.K: Identification of key staff

The Government suggests broad areas and activities for which key staff are likely to be required post-insolvency. These areas and activities would vary and could be further sub-divided depending on individual firms' business models and the relative size of the different business areas. The operating model adopted for the LBIE administration, as described in the Joint Administrators' report, provides a valuable framework to build on, to determine the areas in which key staff may need to be retained.

Business areas: House positions, counterparty claims, Trust property, tax and legal, compliance, information technology, sales/ distribution, market infrastructure.

Activities: risk management and product control, valuation and pricing, trading (for example, derivatives, equities, fixed income), financing and structured products, research, procurement.

Question 28

Are there any other areas and activities for which key staff should be retained? Do you agree with the Government's proposed approach for the firms to identify key staff to be retained?

3.57 Some key staff that might play an important role in the firm's business may not be employed formally by the legal entity concerned, but rather by the parent company, group entities or global affiliates. The Government considers that the firm (as represented by the BRO) should be required to demonstrate to the FSA that suitable alternatives for such staff would be available to administrators if required, following insolvency.

3.58 As discussed previously, administrators need to decide in the first 14 days following insolvency whether they wish to retain the firm's staff and assume the relevant contracts. Administrators may decide in the best interests of the administration that they do not wish to retain some or all of the staff identified by the firm. In such cases, personnel would have to be appropriately compensated. Furthermore, it is expected that at the end of three-month notice period for retained staff, administrators will be able to make alternative staffing arrangements or streamline staff to the extent required.

Contracts with suppliers

3.59 Investment firms are highly dependent on infrastructure and services such as trading and reporting systems, business critical software, broadband services and general IT infrastructure, for their normal business operations. A significant proportion of their annual costs relate to such systems and services.

3.60 However, as discussed above, an investment firm's failure is likely to cause immediate disruption to these systems and processes. Administrators may find it difficult to ensure their continuity post-insolvency, thereby affecting their ability to reconcile client and counterparty positions, locate the assets of the estate and, in general, to wind down the estate in an orderly and efficient manner.

3.61 Again, to deal with this issue, the Government considers that a regulatory solution with firm-level responsibility is likely to be more effective than a legislative one. This is especially so as individual firms' businesses will be structured differently, requiring a more flexible approach.

3.62 The Government's proposed approach is for the FSA to require the firm to demonstrate that contracts with infrastructure and service providers ensure that their services would continue to be available to administrators for at least 90 days of the administration process, to the extent that the services are essential for the wind-down operations of the firm. The firm would have to negotiate contracts with providers of the essential services and infrastructure, such that service provision is not impacted by the insolvency of the firm, irrespective of whether these functions have been outsourced or sold on to a third party preceding or during insolvency.

3.63 The administration activities may also require additional services or applications development during the course of the wind-down. However, despite the availability of "insolvency proof" contracts with service providers, it may be difficult for administrators to contract with them for any new workstreams. The Government does not at this stage propose for firms to be required to demonstrate that such additional workstreams could be commissioned from their service providers. It welcomes views on whether administrators might face practical obstacles in commissioning such work from the same or other service providers and what policy intervention may be required in this context, if any.

3.64 The types of contracts the firm puts in place with service providers will depend upon whether they are third party providers or part of the group. The location of service providers would determine the enforceability of contracts and the extent of dependence on international cooperation. Furthermore, if the service providers themselves become insolvent, their ability to continue providing services to the firm will be limited, and will depend among other things on the insolvency laws applicable to, and administrators of, that entity.

3.65 The Government is of the view that regulatory supervision to ensure contractual arrangements for continuity of essential services precludes the need for some form of mandatory IT on-shoring. Large investment firms are generally organised on a global basis, with IT and data services located in a few different locations to minimise costs and ensure efficiency. Mandating on-shoring of IT centres would mean significant additional costs to individual entities and is likely to be a commercially unviable proposition.

Box 3.L: Contracts depending on nature and location of service providers

The Government proposes that the FSA could require firms to arrange for 'insolvency proof' contracts with service providers. The nature of contractual arrangements will depend on the type of service provision and the location of the entity providing the services.

- Contracts for service providers located within jurisdiction – If these services are provided by affiliates (for example IT support) then the firm could put in place contracts or licences that include a 90-day notice period where a right to terminate is exercised as a result of the firm's insolvency. This would be subject to the service provider being remunerated appropriately, as per the terms of the contract. Appropriate licences and agreements would also need to be in place if data or other services are being outsourced to third parties or being provided by third parties (for example utilities contracts).

- Contracts for service providers located outside jurisdiction – Without a specific contractual provision, administrators will have limited ability to enforce a contract with an overseas service provider. Firms will need to demonstrate effective arrangements and legal provisions in contracts for continued access to service from such providers post-insolvency. The Government will consider whether to require on-shoring of critical data in the absence of alternative solutions.

- Assuming the service provider itself is insolvent or facing liquidity problems at the time its services are required by administrators – Stakeholders have highlighted that there would need to be international cooperation among regulators and administrators of the relevant firms for the exchange of services and information, or at the very least, access to essential data required by administrators for valuation and reconciliation. Regulators could work on developing a generic protocol or a framework that could be amended according to the specific circumstances of an insolvent investment firm, drawing on lessons from the LBIE experience. However, Authorities from international jurisdictions would need to agree on the nature and enforceability of any such protocol.

In addition to these basic contractual provisions, the firm (and/or administrators) would have to ensure that should a part of the business be sold to third parties, transitional service agreements include appropriate provisions for the firm to have continued access to the services of the sold business. Again, this should apply even if the investment firm enters administration.

Box 3.M: Types of suppliers that could be included in this provision

The Government believes that the critical infrastructure and services for which the firm could put in place "insolvency proof" contracts are:

Infrastructure – premises and IT infrastructure (for example, software & hardware systems, existing applications, links to payment and settlement engines and processes); and

Services – utility provision, IT services (for example, licences and subscriptions to access software and services of financial data providers, broadband feeds, ongoing applications and software development), essential catering, back office operations such as data processing, commercial bank services, services by market infrastructure providers including for trading, clearing and settlement.

3.66 There is a risk that service providers may charge higher fees for the provision of their services post-insolvency. Therefore, it is important that when the firm negotiates contracts with them, provisions are made to avoid this situation.

Question 29

What do you consider would be an appropriate measure to ensure that the fees that suppliers charge post-insolvency are not inordinately high? Do you believe the Government can take specific action in this regard?

3.67 In the event of insolvency, the BRO would have to work with administrators to obtain access/control of such services and to ensure that service providers are paid. During the 90-day period following insolvency, the Government expects administrators to be able to streamline services or engage other service providers as required.

3.68 In addition to the firm's responsibility to ensure that essential services continue to be provided in an administration, the Government also considers it important to ensure that the administrators themselves are obliged to continue providing services and facilities to businesses transferred (for example, sold business units) both in the run up to and post-insolvency. This could be addressed through the special administration objectives proposed in Chapter 2.

3.69 A contractual solution to the problem of ensuring continuity of key staff and essential services has the benefit of being flexible. Firms will be able to commission essential services and employ staff as per their business needs, as long as they ensure the continuity of such services in insolvency. The Government believes that just as firms plan for business continuity in the event of technological and other failures (for example, through data backup systems) they would need to make provisions for continuity in an insolvency situation.

Cost-benefit analysis - Question 30

Costs associated with this policy would depend on exact conditions of contracts and the number of key staff or nature of services required. The Government recognises that cross-border groups with investment banking business may negotiate contracts with staff and service providers on a central, group-wide basis. The policy proposed here is likely to lead to additional costs for negotiating contracts specific to individual legal entities.

Stakeholders consider the legal costs of renegotiating contracts for both staff and suppliers to be in the region of £40,000 to £200,000. Although it is possible that these costs may be higher, the Government understands that they are unlikely to be as substantial as costs of on-shoring systems and services. The cost implications of associated policy measures such as an operational reserve for the payment of staff and essential services, the BIPs and BRO are examined in the relevant policy sections.

Do you agree with the cost estimates suggested above, for contractual provisions for key staff and suppliers? What are your views on the incremental costs of: (i) renegotiating contracts with vendors; (ii) putting in place appropriate contracts with key staff and (iii) creating an on-shore IT infrastructure to the extent that it is essential for wind-down in an insolvency?

Question 31

What alternative policy tools could be considered to ensure continuity of essential services and key staff post-insolvency? Are there any likely impacts on the competitive position of UK firms from this proposal?

Operational funding

3.70 Continuity of key staff and essential services during the resolution process depends upon the availability of funds to pay them for their services and to incentivise staff to perform effectively. As discussed above, the Government aims to ensure that administrators have access to the firm's key staff and services for at least the first 90 days of the administration to avoid a "hard stop" insolvency. The Government considers that firms should be responsible not only for ensuring that appropriate contractual protections are in place, but also that administrators have access to sufficient liquid funds for operational expenses.

3.71 It is important to note that the operational funding discussed here is different from the funds the firm or administrators might require to settle or terminate positions with counterparties during the wind-down process. In Chapter 2, the Government discusses policy issues around the availability to firms of such transactional funding, which is likely to be significantly larger than any operational funding.

3.72 With respect to operational funding, the Government proposes a regulatory requirement on firms, as discussed below. The requirement is particularly important in the context of international investment firms which, in varying degree, have the capacity to, and in practice do, manage free cash and liquid resources centrally.

Operational reserve

3.73 The Government proposes that the FSA should consider requiring firms to ring-fence adequate liquid funds on an ongoing basis, to meet operational expenses in an administration.

The FSA currently has powers to impose such 'operational reserve' requirements on a firm's permission under section 45 of FSMA. In the Government's view, all firms under the scope of this consultation should be required to hold the operational reserve.

3.74 The reserve could be calculated expressly by reference to the firm's operating costs for 90 days (including any incentives for key staff to ensure effective performance). The assets would have to satisfy prescribed liquidity criteria and, for the most part, should be held in the UK. Under this proposal, the FSA will have to work with individual firms to determine the exact size and nature of such a reserve and how it is to be implemented.

3.75 It is important that in each case the securities or cash account be free of liens and rights of set off, other than possibly in relation to, for example, the fees of the securities depositary or settlement system in which the securities are held. This provision would ensure that accounts are not encumbered by set-off. For example, if an investment firm has securities in custody with a bank, then the firm's ability to access the cash or securities at any time should not be frustrated because it has given security to the bank over the assets held in custody.

3.76 The Government envisages that the assets would remain in the legal and beneficial ownership of the firm, not to be placed into a bankruptcy remote vehicle or into a trust for the benefit of some other entity. However, the firm must assume that it cannot use the operational reserve prior to insolvency. On insolvency, the assets would be part of the general estate of the firm to be distributed according to the insolvency rules.

Box 3.N: Use of operational reserve

The administrators will be able to use the available assets of the firm, including the particular liquid assets of the operational reserve, to make payments that will have priority in the insolvency as an 'expense'. This is provided, for example, by Rule 2.67 (1) (a) and (f) of the Insolvency Rules 1986 ('expenses properly incurred by the administrator in performing his functions in the administration of the company'). Such expenses include payments like those discussed in relation to continuity of key staff and services.

3.77 The Government is considering whether to introduce legislative changes, using its powers under section 234(6)(f) of the Banking Act 2009, to require administrators to use the operational reserve only for operational expenses and not for any other use under the administration.

Question 32

What are your views on legislative changes requiring administrators to use the operational reserve only for operational expenses?

Cost-benefit analysis - Question 33

Initial discussions with stakeholders indicate that an operational reserve of $25-50 million would be required for the investment firm's prime brokerage business and the annual opportunity cost of such funds is likely to be about 30 to 40 basis points.

In addition, the firm may need to include funds within the operational reserve for incentivising key staff to continue post-insolvency. This is likely to amount to approximately $10-30 million for key staff only of the entire investment banking business of a firm. As above, the annual opportunity cost of such funds is likely to be about 30 to 40 basis points.

Do you agree with the cost estimates suggested above? What is your estimate of the value of the operational reserve for the entire investment banking business of the firm, including monetary incentives for key staff, if any?

Question 34

Do you have any views about the operational reserve proposed here?

Summary of proposals

This chapter sets out a number of cross-cutting proposals for regulated and supervised market actions to ensure that investment firms take responsibility for an orderly resolution of the UK legal entity in the event of failure. The key views and proposals presented in this chapter include:

- The firm appointing a business resolution officer (BRO) at the Board level, with delegated responsibility to co-ordinate and implement the firm-level resolution actions discussed in this chapter, which include all of the proposals below.
- Views on how resolution plans for investment firms could be created and implemented to address investment firm-specific needs. This includes one possible model for the investment firm resolution plans that the FSA could consider taking forward in the context of its broader work on RRPs, and which could consist of internal actions by the firm followed by market-facing resolution actions immediately prior to insolvency.
- The firm setting up a business information pack (BIP) to create a contemporaneous and accurate repository of information for administrators to use in the event of the investment firm's insolvency.
- The firm ensuring continuity of service from key staff and suppliers essential for the continued operation of the business in insolvency, by setting up staff contracts with appropriate incentives and 'insolvency proof' contracts with suppliers.
- The firm setting aside an operational reserve consisting of adequate liquid funds that administrators can use in the event of insolvency to pay key staff and suppliers to continue their services post-insolvency.

These proposals, if taken forward, will be subject to further work and a full cost-benefit analysis by the FSA as per its consultation process, which will be informed by the responses to this consultation.

4 Reconciling and returning client property

4.1 This chapter sets out policy options to enable a more effective distribution of client money and assets in the event of an investment firm insolvency. The proposals in this chapter build on the cross-cutting effective resolution proposals laid out in Chapters 2 and 3. However, unlike the proposals in Chapters 2 and 3, the proposals in this chapter involve substantial pre-insolvency intervention, primarily through regulation.

4.2 The key concern for the Government is to ensure that the legitimate and reasonable expectations of clients for the protection and return of money and assets are met in a manner that allows for the maintenance of a flexible and competitive market for investment business in the UK. The term ‘clients’ refers to those whose money and assets are held by an investment firm.

4.3 Client assets, as referred to in this paper, are the financial instruments that belong to the clients of an investment firm and are held on their behalf by the firm in the course of its investment business. Similarly client money, as referred to in this document, is money that a firm holds itself or deposits with another firm, in a qualifying money market fund or other financial intermediary for, or on behalf of, a client in the course of its investment business.

4.4 These are money and assets that are distinct from the money and assets of the investment firm itself and over which clients have proprietary interest rather than merely a contractual claim. Accordingly, there are expectations that the failure of the firm should not substantially impact the return of such unencumbered money and assets to clients because they fall outside the general estate of the insolvent firm (see Box 4A).

Box 4.A: Unencumbered assets

Assets are considered to be unencumbered if the client has granted no security interest over them and where no lien exists over them (e.g. for outstanding fees owed to the firm). Unencumbered client assets are protected from the administrator and creditors of the insolvent firm.

4.5 The protection of clients’ interests in client assets and client money is a cornerstone of investor protection in the UK, with such interests protected under both the regulatory regime and under the law generally. The expectation of clients of a firm that their proprietary rights will be appropriately protected in the event of the firm’s insolvency is an important part of the UK’s attractiveness as an international financial centre. The UK, unlike some other jurisdictions, makes no distinction between domestic and overseas clients. This contrasts with the priority given to domestic positions in some other jurisdictions that leaves open the possibility that international clients may not have their interests fully protected.

Practical issues with returning client money and assets

4.6 The failure of Lehman Brothers International (Europe) (LBIE) highlighted a number of practical issues which may hinder the ability of an administrator or trustee (or other insolvency practitioner) to distribute client money and assets promptly – including, but not limited to, difficulties in:

- gaining access to the insolvent firm's IT systems;
- reconciling books and records in large, and highly complex, institutions - especially where documentation is unsigned, incomplete or inconsistent;
- ascertaining what are client assets and house assets;
- interpreting the effect and inter-relationship of contracts and master agreements such as Prime Brokerage Agreements, Futures Agreements, Stock Lending Agreements, ISDA Master Agreements and Cross Margining and Netting Agreements, which can be in several forms and individually modified;
- understanding complex intra-group arrangements. An example would be where security has been granted by a client to the failed firm and to all of its affiliates to secure the client's obligations owed to any affiliate;
- establishing the extent of any right of use and verifying that it is compliant with agreements;
- calculating clients' net claims where there are margin lending arrangements in place;
- securing the return of client money and assets from custodians in overseas jurisdictions and from affiliates of the failed institution; and
- determining and allocating shortfalls in client asset and client money omnibus accounts.

4.7 The fact that there have been difficulties in this area is unsurprising. The practical implications of returning client money and assets in the event of the failure of a firm with such complex relationships with clients and counterparties such as Lehman Brothers were always likely to be substantial. The issues facing the administrator of LBIE are not unique to the UK.

4.8 The practical difficulties highlighted in paragraph 4.6 may lead to two problems for an administrator:

- an inability to gain access and control over client money and assets post insolvency; and
- an inability to distribute client money and assets. Difficulties include identifying what trust property clients are entitled to and the liabilities the client owes to the failed firm (and possibly to other third parties, such as affiliates of the failed firm), against which such entitlements might be set off.

4.9 An effective solution to the problems highlighted by the LBIE administration requires a package of measures including market-led measures, regulation and legislation. This chapter highlights regulatory and legislative reforms that are designed to:

- ensure clarity regarding how client money and assets are treated on insolvency, and address possible misconceptions as to the protections in place;

- improve transparency by facilitating the identification and legal categorisation of client money and assets following the commencement of insolvency proceedings and the legal categorisation of a client's rights in respect of those money and assets;
- improve the speed of return of money and assets held on trust to investors; and
- maintain sufficient flexibility in order to enable investors and investment firms to arrive at mutually acceptable outcomes, and to ensure that any new regime is both 'future proof' and has no substantial avoidable negative impacts;

4.10 In addition to the policy options set out in this chapter, the Government is considering the creation of a client assets agency (CAA) for pre-insolvency supervision of client money and assets and the post-insolvency appointment of a client assets trustee (CAT) to handle the identification and distribution of client money and assets. The CAA and CAT proposals are set out in Chapter 5 (see Table 4A) as additional options that would complement the proposals set out in this chapter.

Table 4.A: Policy proposals and structure of Chapters 4 & 5

Ensuring clarity Chapter 4	Increasing transparency Chapter 4
Clarifying how shortfalls in client omnibus accounts are allocated Mandating product warnings on rehypothecation and client omnibus accounts in contractual agreements Encouraging clarity in contractual agreements	Increasing reporting requirements Increasing record-keeping requirements Increasing audited disclosures by firms around client money and assets Making client asset officers directly accountable
Improving speed of return Chapter 4	**Providing clear and effective support for clients Chapter 5**
Supporting the establishment of bankruptcy-remote SPVs Substantial limitations on the transfer of client money Changing the regime in regards to custodians' right of lien over client assets Requiring firms to have the ability to divide client money into different pools Establishing bar dates for client claims	Establishing a Client assets trustee Establishing a Client assets agency

4.11 In exploring options, the Government will have regard to whether they would be commercially feasible, and will assess the respective costs and benefits. The remainder of this chapter sets out proposals under consideration to help achieve each of the desired outcomes set out in paragraph 4.9.

Ensuring clarity

4.12 A number of the criticisms that have been made of the existing UK regime with regard to the protection of client money and assets are based on misconceptions as to how the regime should operate in practice. It is important that clients and providers of investment services have clear and reasonable expectations as to the existing protections that are in place. This section is not intended to be comprehensive but will provide a general summary of existing protections. It is the responsibility of investment firms and their clients to ensure that they are aware of their rights and obligations.

4.13 This section will also highlight the Government's proposals for:

- clarifying how shortfalls in client omnibus accounts are allocated;
- mandating product warnings in contractual agreements; and
- encouraging clarity in contractual agreements.

Clarifying existing protections

4.14 Client asset and money protection is currently afforded under the UK regulatory regime. The Financial Services and Markets Act 2000 (FSMA) empowers the FSA to make rules which apply to authorised persons, including rules relating to client money and assets and rules which create a statutory trust designed to protect clients' money. Such rules are contained in the FSA Client Assets Sourcebook (CASS). CASS requires the segregation of client money into a separate account from the firm's own deposits.

4.15 Although FSMA does not specifically empower the FSA to make rules to create a statutory trust designed to protect clients' assets, CASS imposes requirements on firms to ensure that adequate arrangements are in place to safeguard clients' interests in client assets. These arrangements will generally involve firms holding client assets subject to implied trusts or other proprietary entitlement in favour of the clients.

4.16 The Government notes that the FSA is due to publish a consultation paper on possible changes to its rules on client money and client assets in due course, taking into account the work arising from this and previous consultation papers.

Segregation

4.17 Effective money and asset segregation is the basis of client money and client asset protection in the UK. Except for in exceptional circumstances, clients will have a proprietary interest in money and assets that a firm holds on its behalf where those money and assets have been properly segregated from those of the firm (to the extent that no right of use, otherwise known as 'rehypothecation' has been exercised). These money and assets are also generally considered to be unencumbered (see Box 4A).

4.18 In the case of money and assets held through a pooled or "omnibus" client account, the consensus view under English law is that each client's proprietary interest is a co-ownership interest in the pooled money and assets in the percentage that their interest bears to the aggregate pool. The High Court is currently considering a number of technical questions in relation to this in the LBIE hearing (see Box 4B). The Government is following this case with interest and will reflect on the outcomes.[15]

[15] Note that the situation as to the rights of beneficiaries over a trust is an English law concept and the situation may be different in Scotland.

Box 4.B: Court case on client money rules

On 15 September 2008 joint administrators were appointed to LBIE. Other Lehman group entities around the world subsequently entered insolvency proceedings.

As part of the LBIE administration, the joint administrators have asked the High Court to determine approximately 30 questions concerning how the FSA's Client Assets Sourcebook applies to some aspects of LBIE's affairs.[16] The joint administrators have identified approximately US$2.1bn of client money segregated for clients. Issues considered in the court include:

- at what point the client money becomes subject to the trust – arguments put forward range from on receipt of the money by the firm, to upon proper segregation by the firm into a segregated client account;
- client money entitlement – there are questions on how and when this should be calculated; and
- top-up – whether or not after administration there should be a final reconciliation, past mistakes corrected and the client money pool topped up out of the general estate to the appropriate level.

Rehypothecation

4.19 One advantage of the CASS regime is that it allows flexibility between firms and sophisticated market players, to determine the appropriate level of protection that should apply in the context of their arrangements, taking into account cost considerations.

4.20 Certain clients can agree to transfer full ownership of assets and money to the firm. A client may agree to do this only for the purpose of securing its present, future, actual or contingent obligations. It is also possible for a client to choose to have its assets held in segregated custody but to grant the firm a right of use of the assets. When clients grant investment firms rights of use in respect of their assets, to the extent that assets are rehypothecated, the investment firm takes title to those assets and is able to transfer title to third parties. Such right of use can be limited, unlimited or subject to agreement between the parties. It is often used, for example, to finance margin lending to clients by allowing the firm to use the assets as collateral.

4.21 Whilst such arrangements may be complex, the rules and the legal concepts on which they rely provide a secure basis for the client's assets that remain segregated to be effectively protected on the onset of insolvency. However, complexity increases the risk of practical difficulties arising when identifying and locating specific assets which are held on a segregated basis and when assessing where the client has a proprietary interest over those assets or is only a creditor with an unsecured claim in respect of them. Such practical difficulties may mean that it will take longer on the insolvency of the firm to bring about a return of the client's assets. However, this does not mean that the client's entitlement to such assets is not legally secure.

4.22 Where the client has granted the firm a right of use over certain assets and this right of use has been exercised, the client will no longer have a proprietary interest in these assets. In other words, the extent of any proprietary interest that a client can legitimately claim over assets and money depends on the specific contractual arrangements entered into, and how the client

[16] http://www.pwc.co.uk/pdf/lehmans_order_240909.pdf

money and assets have actually been dealt with. Some of these scenarios and their legal effect are summarised briefly in Table 4B, as set out in the previous consultation paper.

Table 4.B: Types of interest

Scenario	Legal effect
No rights of rehypothecation. Obligation to segregate client assets in individual client accounts.	Client will have proprietary interest over individual account.
No rights of rehypothecation. Obligation to segregate client assets in a global client account.	Client likely to have co-ownership interest (as tenant in common) in global client account.
No rights of rehypothecation. Obligation to segregate client assets but no such segregation takes place.	Client unlikely to be able to trace the assets or substitute assets into investment firm's general securities account.
Obligation to segregate client assets which has been complied with. Rights of rehypothecation exist but these have not yet been exercised.	The existence of rights of rehypothecation per se are not fatal to client's trust interest, but where investment firm has de-segregated the securities (by removing them from the client account) client unlikely to be able to trace into investment firm's general account.
Obligation to segregate client assets (which has been complied with). Rights of rehypothecation exist and have been exercised but equivalent securities have been "returned" to the client account before the commencement of insolvency proceedings in respect of the firm.	Client's co-ownership interest in the client account should extend in proportion to the securities "returned" although this has not been tested by the courts.
Obligation to segregate client assets which has been complied with. Rights of rehypothecation exist and have been exercised; equivalent securities have not been returned to the client account.	Client will have no proprietary interest in securities.
Source: Allen & Overy LLP	

4.23 The Government believes that the underlying existing protections for client money and assets are generally fit for purpose but notes that, currently, there are ongoing court cases around how these protections should be interpreted post-insolvency (see Box 4C).

Box 4.C: Court case determining status of cash generated after LBIE insolvency

PricewaterhouseCoopers (PWC), the firm to which the administrators of LBIE belong, had asked the High Court for guidance on how to classify cash accumulated by LBIE's prime brokerage division after it went into administration last September. Under the technical terms of the client contracts with the prime brokerage division, any money received by the administrator from dividends and payments on securities that remain in the insolvent business could have formed part of the general estate, which would be divided up among creditors. However, Mr Justice Briggs ruled that $3bn of client money generated after the insolvency of LBIE should be returned to clients.[17]

Clarifying how shortfalls in client omnibus accounts are allocated

4.24 The Government understands that it would be beneficial if there were certainty for clients as to how their assets would be treated on insolvency of an investment firm. In July 2004 the

[17] http://www.pwc.co.uk/eng/issues/lehman_client_money_update_211009.html

Financial Markets Law Committee (FMLC) published a paper entitled *"Property interests in investment securities"* that highlighted potential issues to be addressed in this area. Subsequently, the UK Law Commission and the International Institute for the Unification of Private Law (UNIDROIT) have also examined these issues and they have been addressed in the recently agreed Geneva Securities Convention (see Chapter 8). The European Commission proposes to implement this Convention through a new Securities Directive and will start setting out proposals for this in 2010.

4.25 The Government will continue to support these initiatives and, in addition, will actively consider whether steps should be taken at an earlier stage to make provision in the UK as to how shortfalls in client asset omnibus accounts should be allocated post-insolvency. This issue has been highlighted through the responses to the May consultation paper and from the Advisory Panel as having the potential to delay the return of client assets and cause uncertainty to clients over their exposures.

4.26 The broad principle that the Government is considering therefore is to make the allocation of shortfalls in a client asset omnibus account borne by clients pro rata. This principle, as stated by the FMLC,[18] would apply as follows "any shortfalls in the omnibus asset pool will be borne by all participants in the pool in proportion to their entitlements. A shortfall does not arise where the customer's entitlement is contractual only or where pursuant to the agreement between the customer and the intermediary a credit is provisional only, and is reversed or the intermediary disposes of an interest in securities in exercise of a power of re-use."

4.27 The Government is aware that there are arguments against this principle, mainly due to client assets being potentially traceable in a client asset omnibus account. The Government would welcome views on whether this is an issue that needs to be addressed to speed up the return of client assets, and to increase certainty for clients as to how their assets will be treated on insolvency.

4.28 There is also a potential, complementary issue regarding the date at which clients' entitlements to their assets in the omnibus account are calculated. Clarifying this issue may be important to provide certainty to clients over their potential exposure, as the value of the assets in the pool is likely to fluctuate post-insolvency. The Government is aware that this is an issue currently under consideration in the High Court, in regards to the LBIE client money hearing.

Question 35

Should the Government look to provide clarity over how shortfalls in client asset omnibus accounts are treated on insolvency? Should the Government look to provide clarity over when clients' entitlement to their assets should be calculated?

Mandating product warnings in contractual agreements

4.29 In establishing whether further work was needed in relation to protecting client money and assets, it became apparent that there were two separate areas to consider. The first area relates to the hedge fund and prime brokerage model in which rehypothecation of the fund's assets by the investment firm was often a feature. In responding to this, the Government has principally looked at issues connected to property rights and to the disclosures that were made in regards to the contractual arrangements in place between the parties.

[18] *Property interests in investment securities,* Financial Markets Law Committee, July 2004

4.30 The second area relates to more straightforward client money and asset arrangements, and affects a much broader group of investors. The work in this area is focused on the current regulatory protections and considers whether further change may be necessary to reverse erosion from the original purposes of the client money and assets regime.

4.31 The Government believes that there needs to be increased clarity in contractual agreements for clients as to the level and nature of protection they can expect, and how these will operate in the event of insolvency. Although there should be flexibility on behalf of investment firms to offer additional levels of protection to clients at varying costs, the risks attached to these levels should be spelt out clearly to clients.

Rehypothecation

4.32 Hedge funds have commonly agreed to allow investment firms to rehypothecate their assets as it allowed them to gain financing from their investment firm at a much lower cost. Although this was a commercial decision that would have been documented in their contractual agreements with investment firms, the Government believes more could be done to increase awareness among clients over the risks of allowing assets to be rehypothecated.

4.33 The Government believes increased clarity in investment firm agreements setting out the conditions and extent to which an investment firm can rehypothecate client assets would be beneficial. Although some investors are sophisticated and well informed, there are concerns that other investors are not fully aware of the legal consequences of allowing their assets to be rehypothecated (see table 4.B).

4.34 The Government will ask the FSA to consider whether product warnings should be mandated in investment firm agreements that would:

- set out clearly the loss of clients' proprietary rights to rehypothecated assets and the effect of this in the event of the investment firm's insolvency;
- recommend that clients negotiate a limit on the right of use; and
- recommend that clients negotiate when such a right of use can be exercised and for what purpose (e.g. limit use to supporting the client's own financing rather than the investment firm's or other clients).

Omnibus accounts

4.35 It is possible for a client to enjoy the sole equitable and beneficial interest in assets by segregating these assets into a client account designated only to that client. This is not commonly promoted due to the administrative burden (and therefore expense) in ensuring that a separate custody account is maintained for the benefit of the individual client at every level of the custody chain (i.e where ownership is held through a chain of custodians).

4.36 The Government believes that clients should be made aware though of the implications of allowing their assets to be pooled at a custodian in an omnibus client account. It is likely that in the event of an investment firm insolvency there will be delays while the administrator or trustee determines how large the client asset pool is, and whether the firm has complied with obligations to ensure that it holds sufficient securities (or interests in securities) to cover every client's entitlements.

4.37 If there are shortfalls in an omnibus client account the custody agreement will generally provide that any losses be borne pro rata by all of the clients. In the absence of contractual provisions dealing with the allocation of loss, it is likely that the courts would also apply the loss pro rata, unless tracing claims are made over certain assets in the account. The Government will ask the FSA to consider mandating a warning in agreements that would set out explicitly the implications of agreeing to hold client money and assets in an omnibus custodian account.

Question 36

Do you agree with the Government's proposal of mandating warnings over the implications of allowing rehypothecation and omnibus accounts in relevant agreements? Should firms be required to offer clients designated named accounts at custodians?

Encouraging clarity in contractual agreements

4.38 Following the responses to the May consultation paper, the Government understands that there may be a need to ensure clarity over the following areas in contractual arrangements:

- legal group entity which is the counterparty for agreements;
- provisions which potentially affect the protections offered by CASS;
- set-off and liens; and
- event of default arrangements.

4.39 The Government expects to rely on competitive disciplines to deliver the desired clarity over the areas set out in paragraph 4.38. However, should the market fail to offer the services and clarity that market participants seek, the Government expects to consider further whether targeted regulatory action is required.

Legal group entity which is the counterparty for agreements

4.40 There is potentially a need for greater transparency where investment firms use trading entities in other jurisdictions to effect trades, particularly when trading with a certain entity will mean that UK insolvency rules will not apply should the trading subsidiary become insolvent. Increased transparency in this area would enable clients to better assess the risks associated with trading with this entity.

Provisions which potentially affect the protections offered by CASS

4.41 Some of the responses to the May consultation paper raised concerns that there may be a lack of understanding over the protections provided by CASS and how these might be affected by contractual terms set out in agreements between investment firms and their clients. The current CASS rules do not require firms to make explicit statements about the effects of client money and assets rules, and the way in which they operate. However, the Government would like to encourage market action in this area to ensure that, where appropriate, investment firms do include explanatory language in their documentation.

Set-off and liens

4.42 Clients and counterparties are not always aware that many agreements (including industry standard forms) contain provisions that give investment firms certain rights to net and set off assets against liabilities. The Government recognises that clients are free to negotiate on set-off rights between themselves and the investment firm and that this impacts on pricing. The removal of such rights could potentially impact on client collateral requirements and their ability to keep assets in custody, so it should remain a commercial decision to be taken by clients.

4.43 The value of these agreements is not being questioned but clients could be made more aware of their consequences and that they may lose the protections of the CASS regime as a result. The Government would welcome views on the best way to ensure clarity over set-off and netting arrangements.

Event of default arrangements

4.44 Responses to the May consultation paper indicate that many clients may be disadvantaged by a failure to provide contractually for the possible default of their investment firm. The Government believes that guidance could be provided suggesting that agreements contain mutual insolvency event of default provisions. This could, for example, enable a client to crystallise and value the investment firm's obligation to return rehypothecated securities and set off such amount against any liabilities owed by the client.

4.45 Many existing contracts may at present not make full provision for the insolvency of the investment firm, and this may be a matter that can be usefully corrected through market practice and trade associations.

Question 37

Do you agree with the Government's aim to encourage clarity in contractual agreements? If so, how is this best achieved?

Cost-benefit analysis - Question 38

Initial discussions with stakeholders indicate that there would be a one-off cost of £9,000 per warning in legal costs (calculated at 30 legal hours at £300 an hour) for firms to integrate additional text around each of the following areas in standard contractual agreements:

- warnings on rehypothecation; and
- warnings on omnibus accounts.

Do you agree with the costs suggested above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

Increasing transparency

4.46 To achieve the Government's second objective, that of increasing transparency, it is important that there are the means to enable the effective and early identification of client money and assets. Without proper identification and classification it is extremely difficult for an administrator or trustee to return assets quickly. Transparency is also essential to enable clients to have an understanding of how the process of insolvency will affect them.

4.47 The Government is keen to promote a "look-through" principle whereby investors have visibility over their money and assets that are held throughout the custody chain. This will ensure that they understand their potential exposures and the risks to their money and assets. To achieve this it is important that all market participants are transparent in their dealings with their clients, including fund managers with their underlying clients. The Government is currently of the view that this outcome would be best achieved through enhanced regulatory requirements. These measures would include:

- increasing reporting requirements;
- increasing record-keeping requirements;
- increasing audited disclosures by firms around client money and assets; and
- making client asset officers directly accountable.

Increasing reporting requirements

4.48 In the event of an investment firm becoming insolvent it is important that the administrator or trustee is able to both: efficiently and accurately assess the claims of clients to money and assets; and locate and control the money and assets to speed up their return.

4.49 To achieve this, the Government has asked the FSA to consider increasing reporting requirements on investment firms. These increased requirements would provide transparency to clients about how their money and assets are being held and provide the information required by an administrator or trustee to return such money and assets.

Content of reporting

4.50 It is important that clients are aware of the potential liabilities to their money and assets in the event of the failure of their investment firm. Following consultation with the Advisory Panel, the Government is currently of the view that it would aid transparency if certain systemic investment firms who, for example, offer prime brokerage services, reported on the following areas:

- Client positions - there is a need for clients to be aware of the value of their positions on a regular basis so that in the event of insolvency they can make accurate claims to their assets;
- Rehypothecation - clients could be informed daily when their assets are rehypothecated (or moved from the client account to a house account in preparation for use). This would enable them to calculate counterparty risk as they become unsecured creditors to the estate of the investment firm for the return of these assets in the event of insolvency;
- Net settlement - this would involve firms calculating (on a daily basis), the net position of the firm and the client in relation to the liabilities secured by any security interest over the client's assets. This would improve the ability of an administrator or trustee to make a speedier distribution of client money and assets; and
- Client money and assets – it is important for clients to be aware of the location of their money and assets and whether they are held by affiliates. This will help them understand their potential exposures in the event of their investment firm becoming insolvent.

4.51 Following consultation with the Advisory Panel, the Government has decided that end of UK day reporting of the following areas would be the most practical timeframe, with updates from other key trading centres at the end of each of their respective days, to ensure that records are up to date.

Box 4.D: Possible reporting requirements

Client positions

- Value of client positions

Rehypothecation

- Assets that are rehypothecated or moved to the firm's own custodian account in preparation of use and the value of rehypothecated securities compared to segregated custody positions
- Aggregate value of assets utilised under a right of use and identification of the assets concerned at an International Securities Identifying Number (ISIN)/Committee on Uniform Security Identification Procedures (CUSIP) level.
- Exposures which are taken into account in determining the net liabilities against which any rehypothecation limit is set

Net settlement

- Net settlement number

Client money and assets

- Whether client omnibus or client designated accounts are used
- The jurisdiction in which client money and assets are being held (highlighting jurisdictions where client money and asset protections may be affected by local insolvency laws)
- Accounts subject to secondary liens from custodians and the value of obligations currently owed to third-party custodians that are secured by a lien over the account where the assets are held
- Affiliate relationships with custodians
- Proportions of client money held at each client money bank and qualifying money market fund and any affiliate relationships

Addressing practical issues of increased reporting requirements

4.52 The Government is aware that any additional requirements to improve transparency may be subject to potential practical limitations. For example, valuations of trading positions between the investment firm and its clients will quickly become historic in nature and entries in accounts will vary as new trades are entered into and settlements occur or fail. Similarly entries in accounts will change as the right to rehypothecate assets is exercised or rehypothecated assets are returned.

4.53 As a result, the accuracy of each report will be temporary, particularly at a time of market stress that is likely to accompany the failure of a systemic investment firm. However, despite these issues, the Government believes daily record keeping and reporting will significantly enhance the ability of an administrator or trustee to identify client money and assets and will provide clients with the information they require to manage and assess their risk.

4.54 It is also worth noting that as part of the resolution measures being proposed by the Government in Chapter 2, an important component is that reporting systems continue to function after the investment firm becomes insolvent.

Question 39

Do you agree with the Government's proposal of increased reporting requirements for systemic investment firms? If so, are there any issues around the timing or content of reporting that the Government should consider?

Increasing record-keeping requirements

4.55 The Government is considering whether firms should record on a daily basis the information that would potentially be reported to clients. In addition, record-keeping requirements could be enhanced to identify the client's debtor in respect of rehypothecated assets.

4.56 Responses to the May consultation paper highlighted that it may be important to ensure that there is both trade date and settlement date record-keeping on custody systems. This is because trade date systems only show what clients are contracted to receive, not what they actually receive. So if there is a failed trade then, on insolvency, it is possible that the records in the custody systems will not be up to date. To ensure the proper final recording of client assets, settlement date record keeping could be mandated in addition to trade date record keeping for use on custody systems.

4.57 Finally, it is important that all custody documentation is regularly checked to ensure that it is complete, up-to-date, properly signed and correctly filed.

Question 40

Do you agree with the Government's proposals for increased record-keeping requirements for investment firms? Should the Government require settlement date record-keeping, as well as trade date record-keeping on custody systems?

Increasing audited disclosures by firms around client money and assets

4.58 CASS rules currently contain detailed provisions as to the identification of client money and client asset accounts. Firms are required to maintain accounts and records in compliance with client money rules and provide an annual client assets report in accordance with SUP 3.10.4.R. Some of the responses to the May consultation paper suggested that the quality of these client assets reports could be improved. The Government will ask the FSA to consider additional requirements for the annual client assets report in light of the recommendations made by this and subsequent documents.

Question 41

Do you agree with the Government's support for increased audited disclosures by firms around client money and assets? Should Government require firms to make available audited client money and assets reports to clients?

Making client asset officers directly accountable

4.59 To further enhance the scrutiny of client money and assets held by investment firms, the FSA is considering clarifying controlled function 29 - senior management (CF29). CF29 currently applies to client money and the FSA will consult on extending this to client assets. The Government understands that the FSA will consult on requiring oversight of CASS compliance by one individual.

4.60 By clarifying the scope of controlled function 29, the FSA aims to ensure that proper reporting and recording standards of client assets are being observed. By making the direction of client assets a controlled function the FSA can also ensure that the people in charge of directing client property are fully qualified and capable of executing their duties. This will increase the transparency over the management of client property and will help enhance trust in the system, as well as enforcing against breaches. It would also be expected that this person under the controlled function would liaise with the planned business resolution officers as set out in the Chapter 3.

Question 42

Should the Authorities clarify the scope of FSA CF-29 and centralise CASS oversight under one individual?

Cost-benefit analysis – Question 43

Our initial discussions with stakeholders indicate that:

- there could be a one-off cost of $1.5m for a firm to build a reporting system, assuming that they did not have such a system already in place. If it did have a reporting system in place, it could cost an estimated $0.5m to expand its capabilities. Ongoing maintenance of a reporting system could cost up to $2m. Record-keeping costs could be subsumed within the costs of the reporting system;
- requiring firms to increase their audited disclosures could lead to ongoing annual costs of £30,000, based on 200 additional auditing hours at £150 per hour; and
- there would be a negligible cost of clarifying the scope of controlled function 29.

Do you agree with the above costs? If not, please provide an estimate of costs that are likely to occur, stating your assumptions.

Improving speed of return

4.61 Achieving the Government's third objective of securing the return of client money and assets in a timely manner is important, both to the interests of the client, in particular with regard to their being able to meet their own further obligations, and in terms of the general public interest in liquid and stable financial markets. This section covers policy options that the

Government is considering that may help to improve the speed of return of money and assets to clients. Proposals under consideration include regulatory measures and legislative steps, including:

- supporting the establishment of bankruptcy-remote SPVs for client assets;
- substantial limitations on the transfer of client money;
- changing the regime regarding custodians' right of lien over client assets;
- requiring firms to have the ability to divide client money into different pools; and
- establishing bar dates for client claims.

Supporting the establishment of bankruptcy-remote SPVs for client assets

4.62 While the Government is committed to ensuring that the appropriate regulatory and legislative measures are taken to enhance the protection of client money and assets, the Government and the FSA are aware that some investment firms in the UK are now implementing or considering market-led initiatives to address some of the issues raised by the insolvency of LBIE. In particular, some investment firms are considering setting up bankruptcy-remote vehicles for client assets, to ensure that clients can have their assets returned to them in a timely manner.

4.63 These special purpose vehicles (SPVs), which vary depending on the approach being pursued by individual firms, are designed to enable client assets not taken as collateral by way of title transfer or security interest, or that are being treated as excess collateral, to be released to clients promptly upon the insolvency of the firm. These structures, should they prove effective, may operate as a market solution to the problem of securing the prompt return of client assets on insolvency.

4.64 The structures proposed would typically use a separate custodian entity whose sole function would be to hold some of the securities in the client's portfolio. While the custodian entity may be part of the investment firm's group, the Government understands that it would be established in such a way that it is independent of the rest of the investment firm and would continue to operate following the failure of the investment firm.

4.65 In some cases, firms are structuring the arrangements such that the investment firm has no security interest in the assets held by the custodian entity, while other firms are retaining such an interest in favour of the investment firm but are exploring options for ensuring that such an interest will automatically fall away upon insolvency. It may be possible for firms to receive legal opinions that such an approach would operate effectively, or, alternatively, it may be appropriate to investigate whether any such approach could be supported by regulation or legislation.

4.66 Regardless of these questions, each variant of the approach is based around a common intention that, upon insolvency of the investment firm, the excess securities are clear of encumbrances in favour of the investment firm and can be released to the clients by the custodian entity, provided that there is sufficient clarity as to what is owed to each client. The Government supports this objective, welcomes the steps that firms are taking to explore the creation of bankruptcy-remote vehicles, and regards a market response in this area as useful.

Question 44

Should the Government support the establishment of bankruptcy-remote vehicles for client assets through regulatory or legislative measures? If so, how could Government provide effective support?

Substantial limitations on the transfer of client money

4.67 The Government takes extremely seriously the protection of clients' proprietary rights and believes that client money should be easily accessible to an administrator or trustee on insolvency so that it can be returned promptly. The Government is aware that concerns exist about the ability of clients to fully exercise their proprietary rights in respect of client money that their investment firm may have placed in another jurisdiction. This is due to the potential treatment of that money under local insolvency law. The Government will ask the FSA to consider limiting the ability of firms to transfer client money to jurisdictions where local insolvency law could intrude on the protections offered by CASS.

4.68 In addition, difficulties can arise with regard to the international group structure of some investment firms, particularly their use of affiliates to hold client money. It is highly likely, should any major investment firm go into insolvency, that the insolvency would affect the whole of the group, therefore intra-group contagion is likely to present difficulties in accessing client money held with affiliates.

4.69 The Government will ask the FSA to explore the possibility of placing restrictions on investment firms holding client money with affiliated undertakings. One suggestion is that the client money rules might be amended to provide:

- that firms are not permitted to place more than a certain amount of client money with affiliates; or
- that firms are prohibited from using affiliates for holding client money.

4.70 Also, as mentioned in Box 4D, firms may be required to report on a daily basis the list of banks or qualifying money market funds with which they hold client money and the percentage of the firm's client money that is held with each bank or money market fund. This will assist clients in understanding their exposure to the credit risk of those institutions.

Question 45

Do you agree with the Government's proposal of limiting the transfer of client money to affiliates, and jurisdictions where there are potentially interoperability issues with CASS?

Changing the regime around custodians' right of lien over client assets

4.71 Client assets are generally held by a custodian rather than the investment firm itself and in some cases investment firms grant custodians a right of lien, or other security interest, over such assets in respect of their own indebtedness. Clients may therefore find that assets held by a custodian will not be released to them until this other indebtedness is discharged and that, pending such discharge, they cannot obtain access to their assets.

4.72 Firms are already required to obtain letters in respect of client money trust accounts from banks and money market funds acknowledging that the account is a client account. This letter confirms that the bank or money market fund has no lien or right of retention over the account and that it will not seek to combine, net or set off the account against the debts or obligations of the firm. The Government will ask the FSA to consider extending this requirement to all custodian accounts for client assets. Those jurisdictions where this is not achievable could be identified to clients as outlined in Box 4D. To achieve this, it is important that investment firms clearly identify to custodians those accounts that are holding client assets.

4.73 It has been suggested that if investment firms hold their own proprietary assets (i.e "house" assets) with the same custodians as their clients (but in separate accounts), then set-off and liens that may apply can be taken against the investment firm's own assets, rather than against the clients' assets. This would help ensure that client assets are released in a timely manner. The Government would welcome views on this point.

Question 46

Should firms that manage client assets be required to obtain letters from custodians stating that there are no setoff and liens over client assets in respect of liabilities owed in a principal capacity by the firm?

Requiring firms to have the ability to divide client money into different pools

4.74 It has been suggested in some of the responses to the May consultation paper that firms should have the ability to separate client money into different pools, according to the type of investment involved. This would mean that client money held in respect of activities with higher risk profiles, such as derivatives, could be separated from client money relating to simpler products such as cash equities.

4.75 In the event of a pooling event, when client money held by the insolvent firm is pooled into a client money account, the client money pools relating to low-risk activities could be joined with similar accounts, but not with those representing riskier investments. This could reduce the risk of simple savings and deposit-type products being subject to shortfalls, which might arise in relation to riskier investments.

4.76 This approach was contemplated by the FSA in CP38, *'Protecting Client Money on the failure of an authorised firm'* but was not taken forward. The Government understands that under Commodity Futures Trading Commission (CFTC) rules, the client money pool for futures business is held separately from that pertaining to other investment types.

Question 47

Should firms be required to have the capacity to separately pool client money relating to riskier activities?

Establishing bar dates for client claims

4.77 There is potentially a need to accelerate the process of returning client money and assets by including a cut-off date for claims. To achieve this, the Government is considering empowering an administrator or trustee to set a bar date by which clients claiming a proprietary interest in money and assets held by an insolvent firm are required to have lodged their claim.

4.78 The Government would stipulate in regulation the factors that must be satisfied when setting the length of a bar date. Any bar date that may be set should allow for:

- sufficient time for the fact of administration to be publicised;
- sufficient time for affected clients to calculate and submit their claims; and
- practical difficulties in establishing claims, particularly where arrangements are complex.

4.79 There would also be provisions for any affected party of the bar date to contest its length in court. The Government would welcome views on whether the administrator or trustee should have a legal duty to set a bar date or merely the powers to do so if they deem it appropriate.

4.80 Under the bar date proposal, clients would have to submit their claims before the bar date. The Government is aware that different jurisdictions have different requirements in regards to the detail of submitted claims and believes that although clients should aim to make their claims as detailed as possible, in the interests of maximising the value of the bar date, an administrator or trustee should initially accept a claim in short form. The Government believes that allowing initial claims to be relatively brief, will encourage participation in the bar date and will give an administrator or trustee an understanding of the aggregate size of client claims. That said, if reasonable requests for additional information from the administrator or trustee are not complied with, then clients might not qualify for the initial distribution.

4.81 Once all of the client claims had been received, the administrator or trustee would then be able to agree certain claims (for example, where unencumbered assets can be identified clearly) and contest others where set off and lien arrangements may be held in favour of the estate. While the determination of contested claims continues, the administrator or trustee could simultaneously start to pay out on the agreed claims as soon as possible, holding back a certain proportion of assets to cover the disputed claims, or parts of claims, until they were resolved;

4.82 Any client claims submitted after the initial bar date would not be considered for the first distribution, and would either:

- be converted into an unsecured claim against the estate (although the Government is aware that this potentially engages Article 1 Protocol 1 of the European Convention on Human Rights); or
- in the event of a subsequent pooling event, the trust claimant who did not participate in the first distribution could receive a 'catch-up' distribution from the remaining assets (to the extent there are sufficient assets to enable such a catch up distribution to take place). They would then share pro rata with the rest of the claimants in relation to future distributions.

4.83 The viability of any timescales for distribution by an administrator or trustee will be subject to numerous factors, for example, the: complexity of determining what clients are owed against their liabilities to the estate; approach adopted in relation to set-off and liens by custodians; and restrictions on the holding of client money with affiliates.

Question 48

Do you agree with the Government's proposals for establishing bar dates for client claims? How should clients' rights to their money and assets be affected by a failure to summit a claim by a bar date? Should the Government impose a legal duty on an administrator or trustee to impose a bar date?

Cost-benefit analysis - Question 49

Our initial discussions with stakeholders indicate that:

- requiring investment firms to limit the transfer of client money to affiliates could cost around £15,000 (50 legal hours at £300 per hour) in legal costs;
- there could be a one-off cost to firms of £15,000 (50 legal hours at £300 per hour) in legal costs per custodian to renegotiate their agreements over liens. Additionally there could be other charges: for example, custodians may charge a fee (a basis point charge calculated on activity) or they may require average turnover pledged on an account;
- there could be a one-off cost to firms of £15,000-£1m of requiring firms to have the ability to divide client money into separate pools, depending on the extent to which firms already have this capability. There could also be an annual maintenance cost to firms of around £750,000 to maintain these separate pools; and
- there would be negligible costs to clients of requiring them to submit their claims by a bar date.

Do you agree with the costs suggested above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

Maintaining flexibility

4.84 In taking forward any of the proposals discussed in this chapter, the Government is aware of the need to ensure flexibility for market participants, and to protect the UK's leading role as an international financial centre.

4.85 The Government is keen to ensure that the implications of any proposals carried forward as a result of this work do not have substantial unforeseen consequences. It will therefore be important that any proposed solution is proportionate, practical, and avoids creating unnecessary complexity or burden. The financial services sector is constantly evolving and any proposed solutions would also need to be flexible enough to adapt to changing circumstances.

4.86 Finally, it is important to note that the relationships in question in this chapter involve sophisticated investors, who professionally negotiate documentation, often utilising external counsel. The Government is not seeking to undermine the fundamental commerciality of such arrangements.

Question 50

Would the Government's proposals in the area of client money and assets allow sufficient flexibility to enable investors and investment firms to meet mutually acceptable outcomes? Are the proposals 'futureproof' and do they have a limited negative impact?

Question 51

Do you have any other views on the issue of client money and assets that you feel are important for the Government to consider?

Summary of proposals

This chapter sets out a number of proposals to ensure better outcomes for the clients of a failed investment firm. The key proposals discussed in this chapter are:

- Increasing clarity over the allocation of shortfalls in an omnibus account – clarifying the treatment of client assets on insolvency by making the allocation of shortfalls in a client asset omnibus account pro rata.
- Mandating product warnings in contractual agreements – clearly setting out the implications of allowing rehypothecation and use of client omnibus accounts at custodian level.
- Encouraging clarity in contractual agreements – by encouraging investment firms to be transparent over any risks to client money and assets protection.
- Increasing reporting and record-keeping requirements – requiring investment firms to develop capacity for daily reconciliation of client positions and exposures.
- Increasing audited disclosures by firms around client money and assets – increasing disclosures by firms to the FSA around the holding of client money and assets.
- Making client asset officers directly accountable – clarifying FSA controlled function 29, so that FSA is able to ensure that the people in charge of directing client assets are fully qualified and capable of executing their duties.
- Supporting the establishment of bankruptcy-remote SPVs for client assets – to ensure that the return of client assets is not affected by the insolvency proceedings of the investment firm.
- Substantial limitations on the transfer of client money – placing limitations on the ability of investment firms to transfer client money to affiliate entities and jurisdictions where this would be incompatible with protections in FSA's CASS (subject to principles around free movement of capital).
- Changing the regime in regards to custodians' right of lien over client assets – ensuring that the custodian has no lien or right of retention over client accounts and that it will not seek to combine, net, or set off the account against the debts or obligations of the firm.
- Requiring firms to have the ability to divide client money into different pools – client money might be divided into different pools according to the type or risk of investment involved
- Establishing bar dates for client claims – creating a statutory scheme with fixed terms under which client claims have to be received. This should help speed up the process of determining clients' entitlements to money and assets.

These proposals, if taken forward, will be subject to further work and a full cost-benefit analysis by the FSA as per its consultation process, which will be informed by the responses to this consultation.

5 Providing clear and effective support for clients

5.1 This chapter builds on the package of measures set out in Chapter 4 to improve customer outcomes in the event of the insolvency of an investment firm with systemic consequences. The two additional measures described in this chapter require more significant changes to the current insolvency and regulatory regime than the measures described above, and are explored in more detail below.

5.2 The first is a proposal for the establishment of a client assets trustee (CAT). The trustee would be tasked with upholding the interests of client money and asset holders and speeding up the return of such assets post-insolvency. The second is the possible establishment of a client assets agency (CAA), acting as a complement to the CAT proposal, bringing additional benefits to the pre-insolvency supervision of the client asset regime.

Table 5.A: Policy proposals and structure of Chapter 4 & 5

Ensuring clarity Chapter 4	**Increasing transparency Chapter 4**
Clarifying how shortfalls in client omnibus accounts are allocated Mandating product warnings on rehypothecation and client omnibus accounts in contractual agreements Encouraging clarify in contractual agreements	Increasing reporting requirements Increasing record-keeping requirements Increasing audited disclosures by firms around client money and assets Enhancing focus on clients through FSA controlled function
Improving speed of return Chapter 4	**Providing clear and effective support for clients Chapter 5**
Supporting the establishment of bankruptcy-remote SPVs Substantial limitations on the transfer of client money Changing the regime in regards to custodians' right of lien over client assets Requiring firms to have the ability to divide client money into different pools Establishing bar dates for client claims	Establishing a client assets trustee Establishing a client assets agency

5.3 Both proposals would build on the cross cutting effective resolution measures laid out in Chapters 2 and 3. In particular, the CAT role would complement the special administration regime outlined in Chapter 2. Rather than the administrator having a special objective to prioritise the return of client money and assets, he or she would instead have an obligation to cooperate and aid the CAT in returning client money and assets. This would be a mutual obligation, with the CAT under a duty to ensure that he or she only releases encumbered client assets potentially owed to the estate with the agreement of the administrator.

Client assets trustee

5.4 The Government is proposing that the CAT would be a separate insolvency practitioner responsible for returning client money assets to clients in the event of the insolvency of a systemic investment firm. The administrator would retain responsibility for dealing with creditors while the CAT would deal with clients directly, thereby:

- addressing the inherent difficulty faced by an administrator in reflecting the interests of the general creditor pool, and those of the clients who are owed client money and assets by the firm. Managing these duties can delay the return of client money and assets to clients;
- speeding up the return of client money and assets to clients, as the CAT would be tasked with prioritising the return of such money and assets, which an administrator cannot do at present; and
- improving legal clarity regarding the treatment of client money and assets upon insolvency, and enhancing confidence that appropriate additional measures are being put in place to expedite the return of client money and assets to clients in the event of an investment firm insolvency.

Establishment & duties of a client assets trustee

5.5 The Government proposes that the CAT will be an authorised insolvency practitioner, distinct from the administrator, although possibly from the same firm.

5.6 As with the special administration regime outlined in Chapter 2, the CAT proposal is aimed at the largest and most complex investment firms, whose wind-down might have a systemic impact on the market. The appointment of a CAT could however assist in the orderly wind-down of a wider number of investment firms holding client money and assets. The Government is interested in views as to whether the CAT regime should apply to a wider range, or indeed to all investment firms holding client money and assets. This broadening in scope would ensure that all clients holding money and assets with an investment firm are treated equally, and that the regime does not provide potentially preferential treatment to clients of larger investment firms alone.

5.7 A CAT will have a duty to uphold the interests of clients who are owed money and assets and will act solely on their behalf during the insolvency process. The Government proposes that the CAT will have the legal duty to:

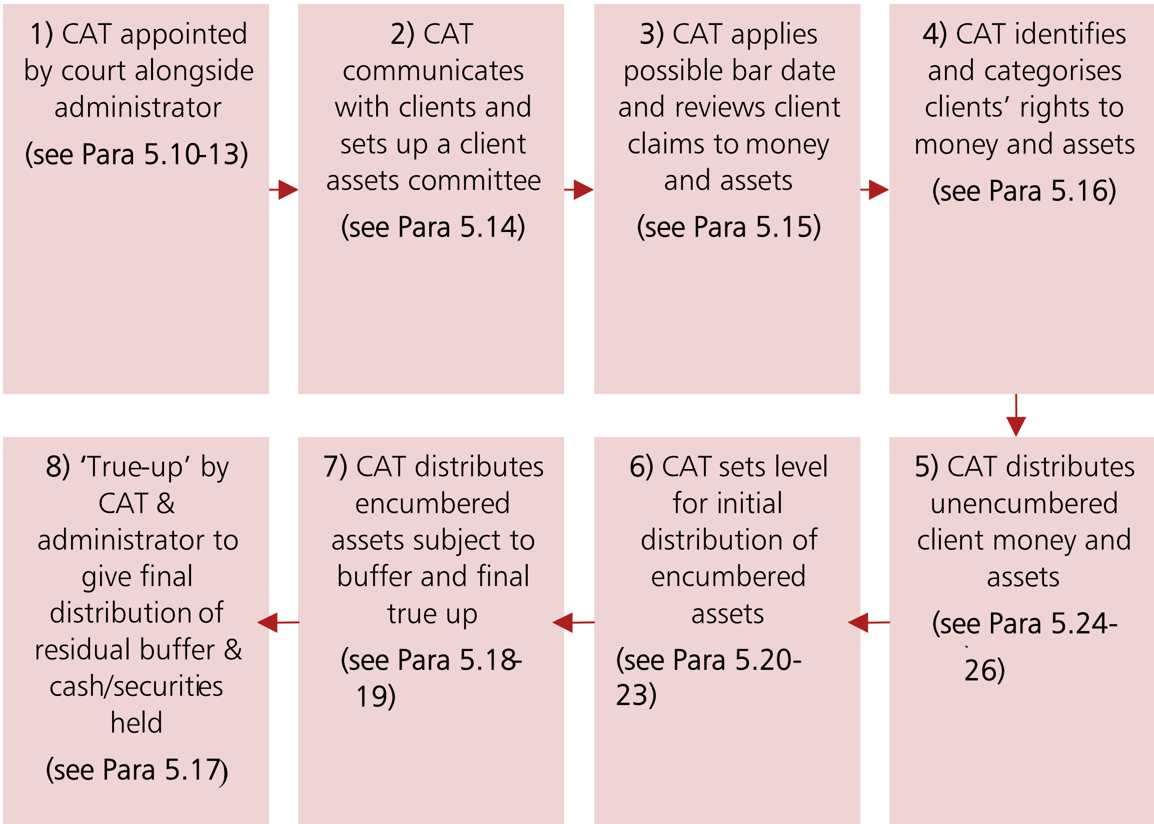
- be accessible to, and communicate with, clients;
- uphold the interests of the client money and assets holders. The trustee will act on their behalf and establish a client assets committee to represent their interests in the administration;
- cooperate with the administrator. This will be a mutual requirement, requiring changes to the administrator's objectives (see paragraph 5.27);
- identify and categorise clients holding client money and assets; and
- review client claims and distribute client money and assets in a fair and equitable way and as speedily as possible.

5.8 Trustee powers, and the manner in which they will be implemented, are laid out in Chart 5A, and paragraphs 5.9-5.26. The Government is proposing that the CAT will set a bar date for clients' claims, and categorise clients' money and assets into those which are unencumbered and encumbered. The unencumbered money and assets will be released as swiftly as possible while the encumbered assets will be held until the administrator is satisfied that they are not required to satisfy a client's liabilities to the general estate. It is proposed however that a proportion of the encumbered assets could be released sooner, based on a 'good faith' estimation of the client's liabilities to the estate.

A model for the operation of the CAT

5.9 The chart below outlines the proposed chronology of events where a CAT is appointed to an insolvent firm. The following section also sets out how a CAT will be established, what their duties will be, and how a CAT will go about returning the encumbered and unencumbered client money and assets of an insolvent investment firm.

Chart 5.A: Chronology of a CAT appointment and return of client money and assets



Source: HM Treasury

Stage 1: Appointment

5.10 The Government proposes that a CAT may be appointed to the firm by the court at the same time as an administrator. The court could consider such an appointment at the request of the FSA, but the company, its directors, or clients holding client money and assets with the firm may also request the regulator to consider such an appointment.

5.11 The regulator will not be under a duty to agree to the request if this is not judged to be in the best interests of the client money and asset holders of the firm. The regulator would however be under a duty to consider whether it was necessary to apply for the appointment of the CAT. Such consideration would be required where delay in the return of the client money and/ or the disruption to the resolution of counterparty assets would, or would have the potential to affect, the stability of the UK's financial system or the maintenance in public confidence in the provision of financial services.

5.12 The Government believes that the trustee could be established in two separate ways, as follows:

- Client assets are vested in the CAT. Under existing administration law, where an investment firm has a trusteeship (as it would over its clients' money and assets), on the insolvency of the company the administrator takes over control of the trusteeship from the directors. In this circumstance, the trust assets remain with the company and do not vest in the administrator. The appointment of a CAT as proposed, however, could result in the client assets being transferred from the insolvent company, to vest in the CAT personally.
- Client assets remain vested in the company. An alternative to this would be for the assets to remain vested in the company and for the CAT to take over the role of the directors in controlling those trust assets. Whilst the CAT would still carry out the same role, this would not require the special insolvency officer to be a trustee in law.

5.13 The Government believes that both of these options are legally feasible, and would welcome views as to the advantages and disadvantages of each, and how these options might operate in practice. It also proposes to seek the views of legal experts in taking this issue forward. The Government considered the possible automatic appointment of a CAT by the court, where the court notes that the firm entering administration holds client money and assets. This was discounted though, as it is proposed that only systemic firms should fall into the trustee regime, and that it will be for the regulator to determine if it considers the investment firm concerned to be systemic in nature.

Question 52

Do you agree with the duties and proposed scope of the CAT? Should the scope be widened to include all investment firms? Should the Insolvency Practitioner be appointed from the same insolvency practice as the administrator or from an independent firm?

Question 53

Do you agree with the Government's suggestions for how the CAT could be established? What do you see as the advantages and disadvantages of the two suggested legal methods of establishing a CAT?

Stage 2: Communicate with clients and set up a client assets committee

5.14 The Government proposes that the CAT should have the power to communicate directly with clients and the market at large, increasing clients' confidence and aiding financial stability. He or she would also establish a client assets committee for those holding client money and assets, broadly mirroring the existing creditors' committee provisions.

Stage 3: Assign bar date for client claims

5.15 In order to allow the CAT and the administrator to determine client claims to their money and assets, the Government is considering whether a CAT should be empowered to set a bar date. Having a bar date could significantly improve the speed with which the CAT could process client claims and start returning client money and assets. The details of how the bar date process would function are laid out in Chapter 4.

Stage 4: Identify and categorise clients' rights to money and assets

5.16 The CAT would access the firm's books and records and obtain relevant information to identify where client money and assets are held (it would also be expected that the CAT would benefit significantly from the increased record keeping that is proposed in Chapter 4). This power would be subject to appropriate limitations, for example, restricting the CAT to records and information pertinent to the role. Responses to the May consultation paper suggested that the actual role of gathering in client money and assets held by third parties should not be split between the administrator and the CAT. The Government proposes therefore that this role should remain the responsibility of the administrator, who would need to cooperate with the CAT in the discharge of its legal duty of mutual cooperation.

Stage 5: Distribute unencumbered client money and assets

5.17 While the return of client money and assets was being sought from the relevant parties, the CAT would work with the administrator to determine which money and assets were unencumbered and which were encumbered. Once the unencumbered money and assets were identified and recovered from relevant third parties, the CAT would release these to clients as swiftly as possible.

Stage 6: Set level for initial distribution of encumbered assets

5.18 Where clients have agreed to some, or in many cases all, of their assets being encumbered, this is generally by way of an English law first fixed charge in favour of the investment firm.[19] This results in the amount of assets being subject to the charge often greatly exceeding the value of the secured liabilities. Where this is the case, the Government believes the CAT should prioritise the return of the excess money and assets to clients to help retain liquidity in markets.

5.19 Encumbered money and assets would be under the purview of the administrator as they represent assets of the firm and not client assets. The CAT and the administrator will therefore need to cooperate and agree on the encumbered assets that can be returned to clients.

Stage 7: Distribute encumbered assets subject to buffer

5.20 It is proposed that the CAT should pay out of a proportion of the estimated client money and assets due to a client, before 'truing up' a final position later. This would provide increased legal certainty to clients, enable a faster return of their assets and increase market liquidity in the event of the default of a systemic investment firm.

5.21 If the CAT is able to come to a view of a reasonable estimated net exposure figure for each client and then make a partial distribution based on this figure, client assets could be returned quickly without materially disadvantaging unsecured creditors. It would be necessary, however, for this process not to extinguish the client's or indeed the administrator's right to "true-up" or challenge the calculation at a later date.

[19] Note that the situation may be different under Scots law.

5.22 To the extent that a subsequent true-up meant that the client owed the insolvent firm an additional payment, then the right of the estate to seek payment would not have disappeared. This would, however, have changed in nature from a claim secured by the company's right to retain the client's assets against full payment, to an unsecured cash claim.

5.23 The Government considers this proposal a reasonable balance between the need to ensure that general creditors are not disadvantaged, and the need to return client money and assets unlikely to be needed to discharge amounts due to the firm, thereby maintaining market confidence and liquidity.

Stage 8: 'True-up' by client assets trustee & administrator to give final distribution of residual buffer

5.24 One consideration is that on the default of an investment firm, it may be found that there is a shortfall or deficit in the segregated client money or assets the firm should be holding for its clients. Such shortfalls are borne (in most cases) by trust claimants pro rata. However, if client assets (encumbered and unencumbered) are to be distributed as quickly as possible, it may not be possible to ascertain the exact extent of the shortfall before distributions start to be made.

5.25 In order to mitigate the effects on creditors of any over distribution by the CAT and to absorb any shortfalls in the pool of segregated assets held for clients, the Government suggests that any distribution of encumbered assets would be subject to the application of a buffer amount. This could be calculated by the CAT as a percentage of the gross exposure number, or as a percentage of the net liability payment.

5.26 Securities and cash to the value of the buffer amount would be retained as client money and assets held for the benefit of the client, but remaining subject to a security interest in favour of the investment firm. Any additional payment to the client owed by the investment firm following a final true-up of accounting would be deducted from the buffer amount. In addition, any final determination of a shortfall in client assets would be apportioned on a pro rata basis per stock line by the CAT, and deducted from the buffer amounts to be returned.

Practical issues with a client assets trustee function

Liability

5.27 The Government proposes that the CAT, like the administrator, would be an officer of the court. In order to avoid delays in the distribution of client money and assets due to personal liability issues, a CAT would need to be able to make net distributions (see paragraphs 5.18-5.21) without any personal liability. In line with the proposals to reduce personal liability for insolvency practitioners discussed in Chapter 2, it is proposed that the CAT be indemnified from the trust property where the CAT had acted in good faith, based on the records kept by the firm, and had shown reasonable endeavours to protect client money and assets held by the firm.

Mutual cooperation

5.28 Any interim determination of the net position of a client necessarily requires the consideration of debts to and from the estate that are normally within the remit of the general insolvency practitioners. This being the case, the Government considers that the CAT would need to be able to make the distribution of unencumbered client assets in cooperation with, but without the need to seek consent from, the administrators.

5.29 The Government recognises that cooperation between the administrator and the CAT is likely to be a particularly challenging area, and that mutual cooperation and communication will be critical. To enable the role to work, both parties will need to share information, systems and records freely and have mechanisms in place to resolve any conflicts that arise (for example differences of opinion over whether assets are encumbered, where both parties therefore wish to claim the assets for their respective creditor pools). To help mitigate this, the Government proposes that the administrator and the CAT would be subject to a mutual duty to cooperate with each other. In addition, the CAT could be appointed from either an independent firm, or from the same firm as the administrator, in the latter case reducing complexity and the costs concerned.

5.30 Both the administrator and the trustee would have the ability to challenge the decisions of the other through the court if required, but would need to weigh up the benefits of doing so against the significant costs concerned (which would be borne by the creditors whose interests they are representing), as well as their mutual general duty to cooperate with each other.

5.31 To address the potential conflicts outlined above, any such measures would need to be very carefully drafted. The Government therefore proposes that this would be done in consultation with senior legal experts in industry.

Funding

5.32 The Government is aware that the creation of a CAT could bring additional costs and complexity, and therefore of the vital need to keep administrative costs to a minimum to protect the interests of all creditors of the firm. If a CAT is appointed, this could be funded either from the client money and assets held by the firm, or from the wider insolvent estate. The Government recognises that there are issues to be considered regarding the equitable allocation of costs, and would therefore welcome views as to the most appropriate method of allocating these costs to enable this area to be considered further.

Question 54

Should the costs of the CAT be funded from the client money and assets of the firm, or from the insolvent estate?

Third Party Custodians

5.33 A number of UK investment firms are in the process of developing third party bankruptcy-remote vehicles for client assets in order to ensure that client assets can be returned swiftly on insolvency, as discussed in Chapter 4. In order to obtain a perfected security interest, investment firms currently require an exclusive right of control over the client assets, and under the existing regime this right of control passes to the administrator of an insolvent firm.

5.34 In the event of a CAT being appointed, the CAT would need to authorise the release of an appropriate amount of excess assets held by the bankruptcy-remote custodian entity, based on the net exposure figures established by the CAT. The CAT would need to be indemnified for this action as set out in paragraph 5.26.

Further Considerations

5.35 It is currently proposed that a CAT role would be introduced in insolvency solely for systemically important investment firms. It is therefore important to ensure that this is not detrimental to the interests of other client money and asset holders, both across the insolvent group and the industry as a whole. The FSA's CASS rules apply equally to all investment firms (large and small) holding client money and assets, and there is a concern that the proposals would provide an advantage to such clients not afforded to the majority of investors holding client money and assets in investment firms.

5.36 There is also a concern that if this proposal is not replicated equally across all investment firms, this could result in different parts of the same group being subject to different (or in the case of a banking group, multiple) insolvency regimes, adding extra complexity and legal uncertainty. Although profoundly systemic in nature, it is arguable that LBIE was also an exceptional case and that the UK administration regime, whilst not without areas for potential improvement, in many ways showed how flexible it actually is as a system.

5.37 The Government also notes the view that a number of the issues delaying the return of client assets are practical rather than legal, (e.g. relating to deficiencies in record keeping, systems issues and lack of contingency plans). As these are being addressed in the overall package of measures contained in this consultation document, it could be argued that these would provide the bulk of the faster redress that it is possible to achieve. This argument would be strengthened further if the administrator had, as one of their special objectives, a duty to prioritise the return of client money and assets, as per the proposal discussed in Chapter 2.

5.38 The Government will consider the above concerns again carefully in light of responses received to this consultation. The Government currently believes however that the proposal to establish a CAT (complementing the other measures set out in this paper), could speed up the return of client money and assets to clients in the event of an investment firm default.

Question 55

Do you agree with the proposal to establish a CAT? Should the Government favour alternative measures for improving client outcomes, such as the proposal in Chapter 2 to amend the legal duties of administrators to require them to prioritise the return of client money and assets?

Cost-benefit analysis - Question 56

It is expected that any additional costs of the CAT proposal would be negligible due to the assumed faster return of client money and assets by the CAT, and the resulting fall in expected administration costs. Do you agree? If not, please provide an estimate of any costs that are likely to occur, stating your assumptions.

Client assets agency

5.39 This section considers the possible establishment of a new CAA. If taken forward, the agency would take over some responsibility from the FSA for the regulation and ongoing supervision of systems and controls relating to client money and assets within FSA authorised firms and play an enhanced role post-insolvency, where required. This option is being considered as the Government believes that the creation of such an agency:

- would enable an individual from the CAA to assume the role of a CAT, where required, in the event of an investment firm insolvency. Where an independent Insolvency Practitioner (IP) is appointed instead, the CAA would sit on the proposed client assets committee, in both cases improving the support for clients post-insolvency, and
- the legal structure proposed for the CAA would provide the additional benefit of enhanced supervisory focus on client money and assets issues.

5.40 In the case of complex insolvencies with systemic consequences, it is proposed that an independent insolvency practitioner would be appointed as the CAT. The Government believes however that, in certain circumstances, a client assets specialist or other designated individual from the CAA might bring benefits to the process and speed with which client assets could start to be returned to clients in the event of an insolvency. This might be the case, for example, where the individual had detailed knowledge and experience of client money and asset operations within the specific firm concerned, or its peers. It is proposed therefore that, if this model is pursued, the CAA would be given the flexibility to assume this role if desired, according to the particular circumstances of the wind-down.

5.41 The Government recognises that increased attention is being paid to client money and assets issues at present, and welcomes the steps being taken by the FSA to develop and strengthen capacity in this area further. The Government believes that this structural reform will ensure that firms, auditors and regulatory Authorities continue to give client money and assets the ongoing prominence and resources required, to maintain investor confidence that the UK is a safe jurisdiction in which to conduct investment business.

5.42 A number of the key advantages the Government perceives might flow from the establishment of a CAA are outlined below.

Pre-insolvency benefits of client assets agency

5.43 There would be a number of potential pre-insolvency benefits:

- The legal duties placed on a CAA would ensure that focus was maintained on the area of client money and client assets.
- More enhanced supervision by dedicated specialist staff in a CAA would improve market and clients' confidence in the supervision of client money and assets.
- A CAA would enable transparency regarding the regulatory cost to a firm of holding client money and assets. The funding model would be for the FSA to determine and consult on. However such costs might possibly be met by those firms authorised to carry out regulated activities that involve them holding client money and assets. An independent client money and assets levy could be added to the FSA fee block structure and annual billing process currently in place. This would enable a clear cost of regulation to be calculated, and would also allow the fees levied to be directly apportioned to CASS work, ensuring that resources are not diverted away to address other competing regulatory pressures.
- The proposed increase in specialist staff (especially regarding systemic or more complex investment firms) would also enable the agency to act as a source of expertise promoting industry best practice in client money and assets matters.

Post-insolvency benefits of client assets agency

5.44 There would also be a number of potential post-insolvency benefits:

- The establishment of a separate CAA would allow the CAT to be appointed from a regulator, if deemed appropriate. Alternatively, the CAA would attend the proposed client assets committee to monitor and potentially challenge the actions of the CAT (assuming that the CAT is appointed from an independent insolvency practitioner and is not a representative of the CAA itself).
- The experience and expertise accumulated by the CAA in the pre-insolvency supervision of investment firms could bring significant benefits to the speed with which client money and assets could be returned to clients in the event of an investment firm entering insolvency.

Question 57

Do you agree with the proposal that an individual from the CAA should be able to perform the CAT role, where this is desired by the regulator?

Proposed agency structure

5.45 The Government is currently of the view that the main options for establishing a new CAA are as a distinct body within the wider FSA (independent but integrated), or a stand-alone fully independent agency.

5.46 The Government currently sees the most benefit in creating the CAA as a distinct body within the wider FSA, operating as a division within the FSA's operational structure and sharing functions where possible, (e.g. staff, HR, operations, finance and enforcement). This would operate in a similar way to the current UKLA (UK Listing Authority) model within the FSA's Markets Division, which regulates listed companies on UK stock exchanges. This would require the FSA to set up a separate department that would discharge its supervisory functions for client money and assets under Schedule 1 of FSMA, rather than requiring the formation of a separate company to carry out such functions.

5.47 The Government believes that this option is more advantageous than a free-standing agency model, as it allows the agency to be focused and accountable while avoiding the duplication of resources and fragmentation of regulatory oversight (in contravention of the Hampton Review guidelines).

5.48 With the establishment of a distinct CAA, it is proposed that the FSA firm supervisors would cede responsibility for all client money and asset supervision to the CAA. The agency would take on the statutory responsibility for oversight of client assets and client money for all FSA-authorised firms on an ongoing basis. How this is delivered would be up to the CAA to determine, but is likely to follow the current risk-based approach adopted by the FSA.

5.49 Following this model, agency staff would remain FSA employees, and would be physically co-located within the FSA offices. This would bring the benefits of integration and communication flow (for example continuation of an integrated ARROW risk assessment process), whilst retaining a clear focus on client money and assets issues alone. This close liaison and integration with other areas of the FSA is considered vital, as the agency would need very close reciprocal liaison with other FSA staff in a number of areas. These include supervision, enforcement (cases are likely to be brought on by more than breaches of CASS rules), and the risk and sector and policy teams (where CASS policy is linked closely with market policy, especially regarding clearing and settlement).

5.50 This legal structure would mean that no 'Chinese walls' would need to be in place between the CAA and the other supervisory areas of the FSA. The agency would also be deemed to have constructive knowledge of all information that is known to the FSA when discharging its regulatory functions. Whilst the governance structure of the agency would be for the FSA to determine and consult on as necessary, the Government considers that this might comprise an executive committee, with powers delegated to it by the FSA board, and with representation at senior level from the FSA. This model would allow the agency to retain operational independence over the management of its day-to-day work and resources.

Question 58

Do you agree with the Government's proposal to set up a CAA? Do you agree that this should be established as a distinct body within the Financial Services Authority?

Agency operating model

5.51 It would be for the FSA to designate the appropriate operating model for the CAA if established. This might, however, include a pool of experienced specialist staff which would enable the agency to develop its role – providing advice, expertise and industry best practice regarding the client money and assets rules and investment firm insolvencies, both internally within the FSA (e.g. to supervisors) as well as externally.

5.52 The client asset supervisor would work with the firm on an ongoing basis through a program of visits and reviews. This would enable the CAA to have an understanding of each firm's client money and assets systems, records, staff, sub-custodians and continuity arrangements as appropriate, as each would be vital in the early stages of an insolvency. The client asset supervisor would also be responsible for overseeing and monitoring the firm's preparation of continuity planning and business information packs for client money and assets.

5.53 The Government also suggests that in the interests of improving client outcomes, the CAA (when not acting as a CAT itself) should be granted the right to sit on the proposed client asset committee. This would include the right to monitor and, if necessary, challenge the CAT if it felt that the appropriate actions were not being taken to return client money and assets.

5.54 Supervising firms is a different skill set to being a trustee or administrator. The CAA might therefore retain a range of specialist staff including supervisory staff to undertake CASS firm visits, insolvency practitioners, and policy and risk specialists. This would enable the agency to engage on a level with an administrator or CAT, and participate actively on a client assets committee.

Question 59

Should the FSA be granted powers to sit on the creditor and/or client assets committee by right, to enable it to monitor and, if required, challenge the administrator or CAT? Should such a power include the right to vote?

Scope & objectives

5.55 The scope of the CAA would be for the FSA to determine. The Government considers however, that this might cover all firms authorised to carry out regulated activities that involve them holding client money or assets, and so falling under the scope of the FSA's existing client money and assets rules contained in the CASS. This would include banks, if client money is not held as a deposit with the bank, or assets that are held arising from investment business. It would also include all investment and insurance firms holding client money or assets. The objectives, accountability mechanisms, and rule-making ability of the CAA, would be for the FSA to determine should the proposal be taken forward.

5.56 The Government believes that staff working for the CAA should be immune from personal prosecution by virtue of Part IV of Schedule 1of FSMA (as FSA staff are now). The agency itself would be open to legal challenge in the courts on the grounds of it acting in bad faith or if it had acted incompatibly with the European Convention on Human Rights. The actions of the CAA may also be judicially reviewable.

Question 60

Should all firms currently regulated by the FSA and holding client money and assets, as defined by the FSA's CASS rules, fall within the jurisdiction of the CAA?

Practical issues to be considered

5.57 The Better Regulation Task Force has pointed out that it is often difficult to attract high-calibre staff to small regulators and that large regulators tend to deliver higher quality regulation. In addition, the HM Treasury team who analysed the issue in 2005, recommended a large number of regulatory mergers because their own analysis had reached similar conclusions, namely that small regulators tended to be less efficient, more expensive, and burdensome on industry and, critically, less effective. The Government is aware of these views and of the following issues that need to be considered:

- The move away from integrated financial supervision. This would result in fragmentation of regulatory oversight, as more than one body would become responsible for regulating different areas within a firm. This potentially affects one of the original concepts behind the formation of the FSA, namely that a single entity should have holistic oversight over the whole of a firm's activities, and that firms only had to deal with one regulatory authority.
- The increased costs of running a distinct, semi-integrated agency, as well as the potential duplication of resources/oversight and communication issues. Whilst these costs will be less than those for a completely independent stand-alone agency, the increase would be material if responsibility for the oversight of all FSA-authorised firms holding client money and assets is passed to it.
- If the CAA is deemed a Competent Authority under the Financial Services & Markets Act 2000, approval may need to be sought from the European Commission under MiFID requirements.

5.58 The Government recognises these issues and will consider them further in light of responses received to this consultation.

Cost-benefit analysis - Question 61

It is expected that the FSA will allocate more resources to client asset risks in the future, to perform work that could be taken on by the CAA. The incremental costs of the CAA are therefore expected to reduce. Do you have any comment on this?

Question 62

Do you have any other views on the establishment of a CAT or CAA that the Government should consider?

Summary of Proposals

The creation of a CAT would involve the use of powers in Part 7 of the Banking Act to either make amendments to the existing Insolvency Act and Insolvency Rules, or to create a new regime to:

- create the role of a CAT in the context of the insolvency, and make provision for its appointment by the Court;
- establish the primary duties/ objectives of a CAT;
- deal with the interaction between the CAT and the administrator acting for general creditors; create primacy of the CAT where required. Indemnify the CAT where he/she has acted in good faith, in accordance with the records held by the firm and has shown reasonable endeavours to protect the client money and assets;
- create a bar date;
- create a client assets committee; and
- establish the form, timings and procedure for the filing of a net client assets claim & interim & final distributions of client money and assets.

The creation of a CAT would require the FSA to make provision in the FSA's CASS rules for the control of client money and assets post insolvency by a CAT, where appointed.

The creation of a CAA would involve the delegation of powers by the FSA to the CAA regarding the statutory supervision of client money and assets held by FSA authorised firms. The CAA would be granted a legal right to sit on client asset committees, and the agency would further develop best practice and expertise in client money.

6 Reconciling counterparty positions

6.1 This chapter sets out proposals designed to improve outcomes for counterparties of a failed investment firm. These proposals should be considered as being complementary to those set out in Chapters 2 and 3, which should maximise the number of positions which close out normally.

6.2 The past decade has seen important changes to market infrastructure in the UK. Whereas participants would once have used the London Stock Exchange (LSE) for all UK equity transactions, they now have a choice of other Recognised Investment Exchanges (RIEs) and Multilateral Trading Facilities (MTFs) through which to carry out transactions. There have also been major changes to arrangements for clearing services for on-exchange and over the counter (OTC) trades.

6.3 The Markets in Financial Instruments Directive (MiFID) was an important factor in these changes, helping to end trading concentration, recognising a broader community of trading venues, and harmonising EU regulatory requirements in relation to pre- and post-trade transparency for shares admitted to a regulated market.

6.4 Increased choice in trading and clearing arrangements has impacted positively on competitiveness. The UK has the largest number of MTFs and CCPs of any country in Europe, and this competition has driven down the costs associated with exchange trading.

6.5 As the Government noted in its May paper, these arrangements have increased the number of routes through which trades may be executed, cleared and settled. Even within one single client transaction, different parts of a trade may be executed through different venues, under different trading and default rules, or entirely OTC. There is therefore a need for robust mechanisms which ensure choice is maintained, and that there is clarity for counterparties regarding what will happen to trades in the event of an investment firm default.

6.6 In the event of such a default, the ideal outcome for the counterparties of the failed firm is that their positions go on to settle. If this is not the case, counterparties need at least to achieve clarity about their positions, and the close-out options available, so they can take the necessary action. The worst situation is uncertainty, in which counterparties cannot take action to hedge their exposures.

6.7 When Lehman Brothers International (Europe) (LBIE) went into administration, over 840,000 pending and failed trades existed.[20] Infrastructure providers, including exchanges, central counterparties and the UK settlement system (CREST) worked with the administrators to clarify market participants' positions. Despite this, counterparties experienced a degree of uncertainty about whether or not trades would settle and what the terms of default would be. In some cases, they also experienced difficulties in transferring margin to complete their transactions through a new clearing member.

[20] *"Lehman Brothers in administration" – Joint administrators' progress report for the period 15 March 2009 to 14 September 2009,* PWC, October 2009, http://www.pwc.co.uk/pdf/lehmans_2nd_progress_report_141009.pdf

6.8 In its May consultation document, the Government committed to arriving at policy solutions for counterparties which:

- protect the diversity and choice of trading, clearing and settlement methods for market participants;
- ensure clarity, and building an environment in which the reasonable expectations of market participants are consistently matched with outcomes;
- ensure that clear and flexible contractual arrangements can be applied consistently and in a manner which secures legal certainty; and
- develop appropriate market and regulatory responses to uncertainty as regards trades not made on recognised exchanges in the event of an insolvency.

6.9 Respondents to the May consultation broadly supported these outcomes, although a number of suggestions for change or clarification were made. The Government believes that, on balance, these remain appropriate objectives to inform policy, recognising that a balance will need to be struck between them in any particular case.

6.10 This chapter explores proposals for achieving these outcomes with regard to trading, clearing and settlement in turn, and then outlines an additional, cross-cutting question around terms of business between investment managers and investment firms.

Trading issues

6.11 After LBIE went into administration, it was not always easy for market participants to establish how their trades would be affected by the default.

6.12 Discussions in the advisory panel indicate that there have been two main reasons for this: insufficient information about the trading venue used and, in some cases, lack of applicable default rules or terms.

Insufficiency of information

6.13 Under existing CREST system arrangements, investment firms may identify in settlement instructions the venue under the rules of which a particular trade was conducted, through the CREST system's "trade system of origin" (TSO) flagging system. Participants may also mark trades as "OTC" or leave this field blank. This system should allow for clear identification, for each settlement instruction, of the relevant venue where the trade was conducted and therefore which rules will apply. This venue identification information is additionally used in the application of stamp duty functions.

6.14 However, after the LBIE insolvency, the LSE found that in CREST, the vast majority of the unsettled equity trades that were flagged with a TSO of 'S', for LSE, were not in fact being conducted under the LSE's rules. The uncertainty caused considerable delays, as the LSE then had to seek out evidence as to whether each individual unsettled trade was conducted under its default rules, or not. This led to significant market uncertainty about the terms under which trades would close out, exacerbating the situation, described later in this chapter, in which there was uncertainty over whether trades would settle in CREST, preventing parties from being able to promptly hedge their exposures.

6.15 Firms' real-time trading and settlement systems are generally highly automated, and configured to report trades to particular venues or OTC swiftly after the trade is executed. It appears that many firms had defaulted their back office settlement systems to submit settlement instructions to CREST identifying the LSE as the trade venue, when in fact they were being conducted OTC and, for example, reported to Markit BOAT. Firms' input of settlement instructions into the CREST system is similarly automated, and it appears that, in a number of cases, the systems defaulted to identifying settlement instructions as relating to trades on the LSE when this was not the case.

6.16 The Authorities have been working with market participants to consider how such issues arose, how firms' systems operate and whether changes need to be made to prevent any future recurrence. The Authorities expect market participants to take action to ensure that these issues are resolved. They will review the position in the second quarter of 2010 and, if the problems remain, may consider regulatory action at that stage.

Cost-benefit analysis - Question 63

Throughout this document, the Government is seeking stakeholder input to assess the likely costs of proposals. Preliminary work with the industry indicates that regulatory action to address incorrect TSO flagging, should it be needed, would have a negligible cost for firms, as it would simply be a matter of reiterating to staff the meaning of different flags and when they should be used.

Do you agree with this assumption? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

Question 64

What action should market participants take to address incorrect TSO flagging? Do you believe regulatory action to address the issue of TSO flagging is needed?

Default rules and terms

6.17 Transactions which are conducted under the terms of a recognised exchange with default rules or cleared through a CCP with default rules, and those over the counter (OTC) transactions subject to bilateral contractual terms or CCP rules which include default rules, enjoy a high degree of certainty and protection in the event of default.

6.18 The Government considers that appropriate default rules and terms promote efficient, well-functioning markets. In the interests of certainty and stability, it believes market participants should agree, or have access to, appropriate default rules or terms that are fit for purpose.

Default rules for trades on platforms

6.19 Part 7 of the Companies Act 1989 provides a number of protections for action taken by an RIE or Recognised Clearing House (RCH) under its default rules, or to enforce its claim over default fund contributions or property provided as margin by a member of the exchange or clearing house who has gone into insolvency proceedings. Effectively, it permits the default rules of an exchange or clearing house to take precedence over certain provisions of insolvency law, allowing an exchange or clearing house to use the collateral it holds to deal with the default without risk of challenge from the appointed insolvency practitioner.

6.20 Since this Act came into force, there have been changes in the landscape of trading and clearing in the UK. An increasing number of transactions take place on Multilateral Trading Facilities (MTFs), to whom these protections do not apply unless the MTF is operated by a regulated market, or novates trades to a Central Counterparty (CCP).

6.21 In line with responses to the May consultation, and to earlier consultation on Part 7, the Government is considering extending protections similar to those of Part 7 of the Companies Act 1989, to MTFs.

6.22 Members of the advisory panel have argued that this change could simplify dealings with counterparties in the event of an investment firm default, and reduce systemic risk. Part 7 type protection could help cover 'daylight risk' in the period of time in which transactions are not with a CCP, and therefore not protected by CCP default rules. Many MTFs already novate to a CCP in real time, keeping this daylight risk low. However, Part 7 type protection could help cover a situation where an MTF novated to a CCP in real-time, but the real-time novation failed, or was delayed, due to system problems. Some MTFs may choose not to have real-time novation to a CCP, or indeed to use a CCP at all. These are likely to benefit the most from this proposal.

6.23 However, there might be risks and difficulties in extending Part 7 type protections to MTFs in this way. There might also be other ways of resolving the issues that extension of Part 7 type protections would seek to address – for example, through market or regulatory action to ensure all MTFs use CCPs and real-time novation, in which trades are sent to the CCP immediately or almost immediately upon completion.

6.24 To achieve this change, powers in the Banking Act 2009 to make regulations establishing a special administration regime, or make necessary modifications to insolvency law, would be used to make provisions which mirror the protections of Part 7 of the Companies Act 1989. Where an MTF has put default rules in place these would, in the event of the insolvency of the investment firm counterparty, take priority over certain specified provisions of insolvency law. The new provisions would also provide for the protection of trades and margin. Contracts made on such an MTF would be afforded similar protection as market contracts made on a recognised investment exchange, for example. As with RIE and recognised clearing houses, the FSA would be given jurisdiction to examine default rules to ensure their compliance with prescriptions on the substance of default rules, set out in the new regulations. Any default rules MTFs did make would need to meet these prescribed requirements.

6.25 The intention of this policy would not be to compel MTFs to offer default rules. Rather, Government envisages at present that these provisions would be extended to cover any default rules MTFs might make.

Question 65

What would be the advantages and disadvantages of extending Part 7 type protection to cover the default rules and trades of Multilateral Trading Facilities for all affected parties, including creditors? What other options should the Government consider?

Default terms for over-the-counter (OTC) cash equity trades

6.26 A number of transactions are conducted 'over the counter' (OTC), rather than through an exchange or MTF. This means that the trade takes place directly between two market participants, without the intermediation of a platform.

6.27 Euroclear UK and Ireland (EUI), operators of CREST, the UK's dematerialised securities settlement system, estimate that of the cash equity transactions input into the CREST system, around 4 per cent by volume and 14 per cent by value are OTC.[21]

6.28 Some of these transactions are subject to CCP rules that include default rules, and some are covered by industry standard arrangements and tailored terms of business. However, in some cases, bilateral trades take place that are not covered by any default rules or terms of business dealing with a default.

6.29 Responses to the Government's May consultation, and subsequent discussions in the advisory panel, have highlighted uncertainty as to what might happen to OTC cash equity positions following the default of a major investment firm. In the LBIE case, there was a lack of clarity about the contractual obligations which applied when one of the parties became insolvent. Legal uncertainty made it difficult for counterparties to predict or hedge exposures, causing a threat to these market participants and implications for financial stability.

6.30 It is not clear that market participants gain any advantage from a lack of appropriate default rules or terms. Rather, the lack of such terms may exist simply as a result of the speed of transactions between institutions, and a misapprehension that LSE default rules will apply.

6.31 Since the LBIE default, a number of investment firms have come together under the auspices of the Association for Financial Markets in Europe (AFME) to offer a market protocol providing default terms for OTC cash equities trades not otherwise subject to the default rules of a regulated market, MTF or similar venue, and where the parties have not themselves separately agreed express provisions that would apply upon the default of one of the parties to the trade. More detail about the Protocol is provided in box 6.A, below.

[21] This figure is calculated from market participants' advice to CREST, and does not take account of incorrect flagging of trades by market participants as described above. It also does not include the volume or value of cash equity transactions internalised over custodians' books or 'clearance services'.

Box 6.A: The AFME Protocol for cash equity trades

In February 2009 the London Investment Banking Association, now the Association for Financial Markets in Europe (AFME), launched an initiative to seek to mitigate certain issues which arose on the collapse of LBIE. The collapse highlighted how, in the absence of pre-agreed contractual terms for over the counter (OTC) cash equity trades, the insolvency of one party can lead to significant legal uncertainty and associated market risk for the counterparties to these trades at a time of extreme market volatility.

The AFME initiative takes the form of a Protocol which will provide a standard set of default rules for trades that are not otherwise covered, either by the default rules of a regulated market, MTF or similar venue, or by existing contractual terms between the parties. Certain parameters will be set for adherents to the Protocol. The Protocol will not apply to trades with LBIE.

The Protocol will be triggered only on an insolvency related event of default of an adhering party. Upon this trigger, the non-defaulting party has the right under the Protocol to terminate all outstanding OTC cash equity trades subject to the Protocol and to calculate any amount then outstanding under the valuation mechanism of the Protocol. This mechanism provides legal certainty between the parties as to the outstanding trades between them and allows for better management of the associated market risks by the non-defaulting party.

The Protocol is being established to apply between larger broker/dealers located in a few European jurisdictions (including England and Wales) who trade OTC on a principal to principal basis at first. The intention is to provide a solution for a significant proportion of the wholesale market adversely affected by LBIE's collapse as quickly as practicable. However, AFME foresees that the scope of the Protocol can be extended incrementally where there is demand. AFME welcomes views on areas for expansion. Areas for consideration include jurisdictions and types of counterparties covered as well as the concept of agency trading.

It is expected that a website will be built for adherents to access information about others who have chosen to adopt this solution and the legal advice supporting the Protocol.

6.32 Respondents to the May document agreed that the lack of default terms for this group of trades could undermine certainty, but were divided over the best remedy. Some respondents believed a statutory solution was necessary. However, many respondents, and many members of the advisory panel, were in favour of this market solution.

6.33 Although the Protocol is currently limited in coverage, many in the Government's Advisory Panel took the view that it represented an effective first step, which should be extended in future. Members felt that the Protocol had the advantages of being developed and in operation rapidly, and of being flexible and adaptable to the needs of the market.

6.34 Since the publication of the May consultation document, the Financial Markets Law Committee (FMLC) has expressed support for the Protocol, while suggesting that regulatory measures may be needed to ensure the Protocol applies across the market.[22]

6.35 The Government is also aware that there is a debate regarding the valuation mechanism to be used in the Protocol, and, in particular, over whether valuation should be gross or net.

6.36 Under net valuation, a party would be entitled to terminate "covered trades" (those not done on the rules of an exchange or otherwise subject to default rules) upon the insolvency of

[22] *Issue 140 – Unsettled OTC Trades*, Financial Market Law Committee, September 2009, P.9 paragraph 1.16

another part adhering to the Protocol, value those terminated trades and calculate a net sum owing between it and the defaulting party. Under the alternative, gross methodology, the last step would be different. The gross methodology would permit the non-defaulting party to claim any losses it had made on the terminated, covered trades, without having to set off such losses against any terminated covered trades on which it had made a profit.

6.37 The details of this mechanism are a matter for the market, but Government will be looking for a solution which, amongst other features:

- is simple and straightforward
- provides legal clarity; and
- is effective across the jurisdictions covered.

6.38 The Government and FSA will closely monitor the development of the market Protocol for OTC cash equity trades over the coming months, and will assess the suitability of its uptake, scope and terms. This will include an assessment of the proposed valuation methodology against the criteria above. The Government and the FSA stand prepared to put in place a regulatory or statutory solution if these aspects do not develop satisfactorily.

6.39 The Government and the FSA will assess progress on the Protocol at the time of the next paper, and will take a view at that point as to whether further action is needed.

Question 66

Do you agree that the AFME Protocol is a sufficient solution for the issues identified around OTC cash equity trades not covered by default rules or default terms of business? How could the Protocol be improved?

Question 67

Do you believe the AFME Protocol, or an equivalent, should be placed on a regulatory footing? What would be the advantages and disadvantages of this step?

Question 68

Do you have views on the valuation mechanism which should be used in a market Protocol on OTC cash equity trades? In particular, should it be gross or net, and what would be the advantages and disadvantages of each methodology?

Question 69

Are there any other asset classes that the Government should consider for which lack of default terms has proved problematic in the event of the insolvency of a counterparty, or may in the future? If so, please specify.

Clearing issues

6.40 Discussions with the advisory panel indicate that there are two key, related issues at clearing: portability of margin, and segregation of investment firm and client accounts at clearing.

Portability of margin and positions at clearing

6.41 In the event of a default of a clearing member which clears both house and client trades through the CCP, the non-defaulting clients may wish their trades to be taken up by another clearing member and continue, rather than to be closed out due to the default of their clearing member.

6.42 The CCP default rules may allow cleared transactions held in the client account of the defaulted clearing member to be transferred to an alternative clearing member, along with the initial margin held by the CCP in respect of each cleared trade. This enables the defaulted clearing member's client to complete the trade through another clearing member. Part 7 of the Companies Act 1989 protects such a transfer from challenge by an insolvency practitioner, if it takes place under the default rules of a CCP.

6.43 This portability of positions and margin is desirable because it helps maintain liquidity in markets following a default. If the CCP is unable to transfer the margin posted for a particular transaction then, even if the trade transfers successfully to a new clearing member, the client will need to post more margin, further reducing their available funds. Alternatively they may be obliged to close-out their positions, risking a fire sale. Portability of positions and related margin is also desirable because it is likely to encourage use of CCPs.

6.44 Through discussions with advisory panel members, the Government understands that the primary difficulties with transfer of margin relate to a lack of available margin at central counterparty level, and a specific issue related to the corresponding trade conducted between the client and the clearing member.

Lack of available margin at central counterparty level

6.45 A CCP may call for margin on a net basis across all the trades conducted by the clearing member. However, the clearing member will usually call for margin on a gross basis from its clients as it faces the full gross exposures. It may also call for additional margin from its clients due to particular risks or concentrations of positions. Any margin received from the client and not posted up to the CCP will be held by the clearing member. In the event of a default, a CCP that holds positions margined on a net basis will be unlikely to hold enough margin to enable individual trades to be successfully ported to another counterparty with sufficient collateral.

6.46 One solution to this would be to require that margin is calculated on an individual client or 'gross' basis by all CCPs. However, initial discussions between FSA, CCPs and clearing members suggest that a requirement for CCPs to calculate margin on a gross basis, along with individual account designation, may have a negative unintended consequence on market participants and the UK as a place to do business.[23]

6.47 The Government understands that clearing member firms and CCPs across the globe are developing solutions in the OTC derivatives space to permit portability of margin. Major buy and sell side institutions, as set out in a letter to the New York Federal Reserve Bank on 2nd June

[23] DP 09/02 – A Regulatory Response to the Global Banking Crisis – March 2009 - p. 178

2009[24] and copied to the FSA, have pledged to introduce customer initial margin segregation and portability of customer transactions no later than 15th December, 2009. The Government understands that a number of CCPs are developing solutions, which include holding the difference between gross and net margin at the CCP rather than at clearing member level in order to permit buy-side access to margin.

6.48 The Government and FSA will monitor these market developments with interest over the coming months, and will revisit the issue if market developments do not provide sufficient resolution.

6.49 In addition, the FSA, along with the Government, is considering what changes may be needed to the FSA's Client Asset Sourcebook (CASS) rules in order to provide for how investment firms deal with client money when it is transferred to an exchange or CCP, or to ensure clearing members offer the choice of a segregated account to their client. Use of segregation of house and client accounts would make it easier for CCPs to identify client positions and to transfer margin that is held at a CCP level. This issue is explored in more detail later on in this chapter.

Portability of client underlying trades and margin

6.50 A client trade cleared through a CCP usually consists of two trades: one between the client and its clearing member, the other at CCP level between the clearing member and the CCP.

6.51 Where a clearing member investment firm enters default proceedings, its clients may wish to complete their trades through another clearing member. Currently, actions taken under a CCP's default rules, which may be drafted to include the power to transfer trades and margin from one clearing member to another, through the central counterparty, are protected under Part 7 of the Companies Act 1989. However, Part 7 protection does not apply to the underlying contract between the clearing member and its client, or the associated margin.

6.52 One solution, suggested in the advisory panel, might therefore be to extend the protections of Part 7 to help give certainty that all parts of the transaction may be ported across to a new broker. This could in part be achieved by making regulations under section 155(4) of the Companies Act 1989 to provide that, for the purposes of sections 158 -165, market contracts include underlying client trades.

6.53 The trades between the CCP and Clearing Member relating to a Clearing Member's client business are already capable of being protected by Part 7. The aim of this change would be to remove practical barriers to the way that these protections may be exercised on a default, by ensuring Part 7 applies to the underlying contract as well in order to allow the whole trade to transfer successfully.

6.54 However, the Government is aware that any extension to Part 7 has potential to impact negatively on unsecured creditors. Other changes are likely to be required to Part 7 to overcome difficulties faced in transferring business between clearing members. The Government intends to explore these issues in full, in consultation with the Insolvency Service and with cost-benefit analysis, as part of the joint Treasury-FSA review of Part 7 of the Companies Act 1989[25].

6.55 In the meantime, the Government would welcome views on the advantages and disadvantages of extending Part 7 to cover client underlying trades.

[24] See Federal Reserve press release June 2, 2009 http://www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html

[25] *Summary of responses to consultation on amendments to Part 7 of the Companies Act 1989*, HM Treasury, December 2008

Question 70

What would be the advantages and disadvantages of extending the protections provided by Part 7 of the Companies Act 1989 to cover underlying client trades for clients, counterparties and creditors? Can you give any indication of the possible costs and benefits of intervention in this area, and its distributional impact?

Question 71

Are there any other solutions the Government should be considering to promote margin portability?

Segregation of investment firm and client accounts at clearing

6.56 Currently, market practice amongst CCPs is that client positions can be held in an account with the central counterparty in one of two ways. They may either be co-mingled with the assets of other clients and the investment firm's own positions in a house account, or they may be held separately in a client account. Co-mingling allows some economies on margin, as positions may be netted together with the clearing member's proprietary business, leading to a reduction in the amount of margin required by the CCP from the member.

6.57 Following the LBIE insolvency a number of market participants expressed concern about the lack of protection offered to them by co-mingled accounts. There were difficulties in establishing the identity of the assets and asserting their rights to them.

6.58 The FSA consulted on the issue of account structures at clearing level as part of its discussion paper, DP 09/2. It proposed four different possible scenarios:

- maintenance of the status quo, although with a requirement for greater transparency and disclosure of the segregation arrangements to market participants;
- the introduction of an explicit requirement that clearing houses offer facilities for their members to segregate client business (effectively formalising current standard market practice in the UK, but giving FSA greater traction over overseas clearing houses that wish to provide services in the UK);
- the introduction of a requirement that all client business be held on a segregated basis; and
- the introduction of a requirement that client business must be held in a client-specific (i.e. one account per client) 'designated' account and/or that all client business must be margined on a gross basis.

6.59 The responses FSA received suggested strongest support amongst market participants for a choice of account structures at CCP level for client business – although there was also support for the segregation of client business, and for maintenance of the status quo. Respondents were generally not in favour of requiring the use of designated segregated accounts for client business and noted that such a requirement could result in significant costs, including the loss of netting, which may adversely affect the UK's competitive position.

6.60 FSA concluded there would be value in the introduction of an explicit requirement that CCPs offer facilities for their members to segregate client business. This change could be achieved by making minor changes to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001. These changes will also need to be considered alongside the issues identified in paragraph 6.79.

6.61 FSA did not consider mandating the segregation of client business to be appropriate, but committed to be mindful of any arrangements which could artificially restrict choice. It committed to consider whether any resulting changes should be made to the relevant section of the FSA Handbook.

6.62 Respondents to the Government's May consultation and members of the advisory panel thought a choice of accounts was key. A number of advisory panel members felt it would be worthwhile to formalise the practice, common to all CCPs in the UK, of offering segregation. However, members were divided over whether it was necessary or possible to go further than this. Participants from the buy-side argued there should be an explicit requirement for investment firms to offer facilities to segregate client business.

6.63 The Government considers that choice is key. Clients can benefit from net margining efficiencies of unsegregated accounts, provided they fully understand the risks of opting for such an account structure. However, it is mindful of the buy-side concern that investment firms may not always offer a segregated account, or may do so at a cost which makes it unfeasible.

6.64 The FSA is examining whether there may be a case for tightening the CASS (client asset) rules for clearing member investment firms, to consider whether they achieve the FSA's objectives in this regard. One option would be to introduce a requirement for investment firms to offer facilities to segregate client business. The Government and the FSA would welcome stakeholders' feedback on this point.

Cost-benefit analysis - Question 72

Initial discussions with stakeholders indicate that there would be negligible costs for market infrastructure providers and market participants in mandating the offer by CCPs of segregated accounts, as this is already offered as standard by CCPs in the UK. The Government would welcome comments on this assumption.

Initial discussions also indicate that mandating investment firms to offer a choice of account at clearing would have an average one-off cost, per investment firm, in the region of US $5-10 million for an investment firm to develop this capacity, and an approximate annual maintenance cost of $5 million. The Government would welcome feedback to improve this estimate and, in particular, how it might impact on firms of different sizes.

Do you agree with these costs? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

Question 73

Do you agree there would be value in the introduction of an explicit requirement that CCPs offer facilities for members to segregate their business?

Question 74

To what extent is it necessary to require clearing member investment firms to offer their clients a choice of account types for the purposes of clearing? What would be the advantages and disadvantages?

Other clearing issues

6.65 The UK Authorities are facilitating the drawing up of guidelines by CCPs and representatives of insolvency practitioners that seek to improve the timeliness, efficiency and quality of co-operation between these groups in the event the insolvency of a clearing member. The draft guidelines have been extensively reviewed and are progressing and further information will be available during 2010.

6.66 The Government is aware that there are outstanding issues in relation to client money which may impact on clearing arrangements and, in particular, issues highlighted in the context of the most recent consultation on Part 7 regarding the extension of protections in relation to client money.[26] The Government intends to explore this issue in due course as part of the joint Treasury-FSA review of Part 7 of the Companies Act 1989.[27]

6.67 The Government would welcome views as to whether there are any other issues the Government should be exploring as regards clearing and investment firm insolvency.

Question 75

Are there any other issues which you believe need to be resolved at clearing level, regarding the insolvency of an investment firm? If so, please provide details.

Settlement issues

6.68 The 'CREST' system, operated by Euroclear UK and Ireland (EUI), is the UK's dematerialised securities settlement system. Where there are transfers of legal title in participating securities, it represents the last stage in the chain of trading, clearing and settlement, simultaneously transferring title and cash between counterparties.

6.69 Following the LBIE insolvency, there was a period of uncertainty as regards what would happen to unsettled settlement instructions in relation to transactions with LBIE.

6.70 Under current arrangements, CREST immediately disables participants on insolvency, preventing further settlement. EUI will then consider whether settlement should be resumed. It will do so in consultation with regulators and insolvency office holders, and taking into account market factors including exchange and CCP default rules as well as wider systemic implications. Where re-enablement is not possible (for example, if underlying trades have been closed out under a recognised exchange's default rules), both the insolvent entity and its counterparties must input deletion instructions into the CREST system to remove the pending instructions which will never settle. At the time of the LBIE insolvency, EUI was not legally permitted to intervene and centrally remove or delete pending settlement instructions. As a result, and due

[26] *Summary of responses to consultation on amendments to Part 7 of the Companies Act 1989*, HM Treasury, December 2008
[27] *Summary of responses to consultation on amendments to Part 7 of the Companies Act 1989*, HM Treasury, December 2008

to the vast numbers of counterparties involved, instructions remained in the CREST system for over three weeks after the appointment of the LBIE administrators.

6.71 Consequently, some non-defaulting counterparties lacked certainty about what had happened to the settlement instructions disabled in the CREST system, whether they would be settled and, if so, when settlement would occur. This reduced participants' ability to manage their exposure.

6.72 After a period of delay without market agreement, and following discussions with the FSA, the operator of the CREST system, EUI, in response to this uncertainty and increasing systemic risk, exercised its default powers against LBIE and counterparties. It directed LBIE and all counterparties to open settlement transactions to enter a 'match delete' instruction. This removed the transactions from the CREST system and provided certainty to the market that settlement in the system was not going to occur.

6.73 Advisory panel members expressed concern about the market risk this period of uncertainty caused. They stressed that the key was to avoid a situation in which firms could not achieve certainty about their exposures, and therefore hedge these positions.

6.74 After discussion with the Government and other market participants, EUI has come up with a proposal to prevent uncertainty at settlement in future. This is described in box 6B below. Under the proposal, EUI would permanently freeze pending instructions relating to an insolvent entity, by either moving them to a shadow account or having their status clearly identified as never to settle.

Box 6B: EUI's revised approach

In the light of experience from the LBIE insolvency, and following initial consultations with a range of market bodies, EUI is now proposing a revised approach to the handling of pending settlement instructions in relation to insolvent CREST participants. The revised approach reflects the current approach which EUI adopts in relation to investment firm insolvency. However, EUI would retain no discretion to determine the action it should take.

This approach would involve EUI, following receipt of notice of the insolvency of a CREST participant, taking steps to disable that participant. All pending settlement instructions in the CREST system in relation to that insolvent entity, whether on exchange or OTC, would then be removed from the settlement process and would never be re-enabled for settlement. The pending instructions would be 'frozen', potentially being moved to a 'shadow' account or having their status clearly identified as never to settle. EUI is currently considering the detailed options in relation to technical implementation of such a solution (including with a view to eliminating or minimising development impacts for CREST participants and to the CREST system).

It would therefore be clear, effectively from the moment EUI disables the participant, that all settlement instructions in respect of that participant would never settle. Full transaction and status information would remain available for counterparties (and the insolvent entity) to be able to query and reconcile their positions.

As a second stage, following a suitable period (such as 60 business days, in line with other CREST system archive arrangements), the frozen pending instructions would be centrally removed from the CREST system. No input of matched deletion instructions would be required of CREST participants. In order to achieve this, a minor amendment needs to be made to the Uncertificated Securities Regulations 2001 to enable EUI to take action centrally to delete instructions in these circumstances.

6.75 EUI have drawn attention to certain issues, which must be considered alongside the benefits this measure could bring. These are:

- Delay in meeting trading obligations. As a result of the freezing (and subsequent deletion) of all pending settlement instructions, should the appointed insolvency practitioner and counterparties wish to settle existing trades, new instructions would have to be inputted into the CREST system. There are likely to be logistical difficulties for this to happen in a timely fashion. Consequently there is an increased likelihood that the insolvent entity will be unable to meet its trading obligations in a timely manner.

- Lack of EUI discretion. EUI would retain no discretion as to the approach to be taken in particular circumstances. This would be the case whether the insolvent entity operated on a retail or wholesale basis. Even in circumstances where the insolvency practitioner (and market counterparties) wished for the insolvent participant to be re-enabled and settlement of pending instructions to take place, this would not be possible until new settlement instructions had been inputted. This may impede an orderly operation or wind-down of a company in administration, and increase disruption for clients of the insolvent entity.

- Increased likelihood of default. It would not be possible for EUI to distinguish exchange and OTC trades in the time available and all pending instructions in relation to exchange trades would also therefore be removed from settlement along with those relating to OTC trades. This, and the need for the insolvency practitioner (and counterparties) to re-input instructions, is likely to impact the ability of the member to fulfil its obligations under exchange and clearing house rules in a timely manner. Therefore there is an increased likelihood that the insolvent entity will be unable to meet exchange or clearing house obligations, and consequently an increased likelihood of the entity being declared in default by exchanges and clearing houses.

6.76 The Government welcomes this proposal, which received much market support through the advisory panel. The Government notes that the Financial Markets Law Committee (FMLC) recently expressed support for EUI's proposal as the most effective and least costly option to increase confidence, while noting the potential drawbacks this solution would have. [28]

6.77 On balance, stakeholders believed the benefits of greater certainty outweighed the potential problems described above. However, the Government welcomes EUI's commitment to further consultation and cost-benefit analysis to establish that this is indeed the best solution.

6.78 The Government and the FSA would welcome views as to whether there are any ways in which EUI's proposal could be improved. The Authorities will monitor the EUI proposal to prevent uncertainty of settlement closely over the coming months and will appraise market progress in this area in spring 2010, with a view to taking action if the issue has not been sufficiently resolved.

6.79 An amendment to the Uncertificated Securities Regulations 2001 (USRs) would need to be made to ensure EUI could implement this change. This is because a relevant system (i.e. the CREST system) must only respond to "properly authenticated dematerialised instructions" ('PADI') which are attributable to a system-user or an operator. 'PADI' are such if they comply with certain specifications set out in Schedule 1 of the USRs, and EUI is at risk of challenge if the CREST system responds otherwise than on the basis of a PADI. The change to the USRs would

[28] *Issue 140 – Unsettled OTC Trades*, Financial Market Law Committee, September 2009

involve the insertion of a new paragraph into Schedule 1 to provide that the other provisions of Schedule 1 do not prevent certain actions being taken by the Operator.

6.80 Although a large proportion – approximately 85% by value – of settlements of UK equities in issue are effected through the CREST system, the Government appreciates that settlement venues in other jurisdictions are also used to settle trades. The Government will monitor progress of settlement systems in other jurisdictions, and will seek where possible to ensure greater certainty can be provided.

Question 76

Does EUI's proposed approach to settlement provide greater predictability and are there ways it could be improved?

Question 77

Have the key consequences of EUI's proposal to increase certainty of settlement been identified correctly and do the benefits for the market as a whole of the proposed revised approach outweigh these consequences?

Terms of business between investment managers and investment firms

6.81 Many of the issues discussed in this chapter relate to a perception of legal uncertainty about the terms under which trades are executed and will close out. Where such concerns exist, they may be resolved in part through the market measures and changes to infrastructure arrangements described above. However, the Government is aware that, in addition, there may be broader, underlying uncertainties about aspects of the contractual terms under which investment firms and investment managers conduct business.

6.82 The Government is aware that, in some cases, a situation has arisen in which investment firms issue contractual terms to fund managers, who in turn attempt to rebut the terms in whole or in part, sometimes sending back terms of their own and asserting their primacy. Sometimes agreement is never reached, and where it is may be overturned by subsequent changes. This exchange of terms, and resulting lack of certainty, is colloquially referred to as "the battle of the forms".

6.83 Both buy- and sell-side representatives agree that the "battle of the forms" needs to be tackled in a way that reflects the nature and risk of their respective businesses, and delivers the certainty that all parties require. Representatives from both these groups have committed to engage in discussions on the core points, with the aim of achieving resolution.

6.84 The Government understands that buy-side concerns hinge around ensuring terms are not disadvantageous to the investment manager or clients. In particular, buy-side representatives want to ensure that:

- terms adequately reflect the legal status of the fund manager as an agent for its clients, and address the consequences (for client, manager and investment firm) which flow from the manager's agency status; and

- the capacity in which the investment firm acts, at the time of trading or when the transaction is confirmed, is sufficiently clear.

6.85 Buy-side representatives have argued some aspects of contractual terms – for example, the agency status of a discretionary fund manager – should be dealt with in regulation or legislation.

6.86 For their part, sell-side representatives have said they need to ensure that any solution is consistent with the legal, regulatory, risk management, and commercial concerns of investment firm dealers. They have argued that, as the identity of underlying clients is often not disclosed, and given the importance of having recourse to a known counterparty, the investment firm need to be able to treat investment managers as jointly and severally liable with the underlying funds. While acknowledging the importance of addressing the question of agency or principal status, sell-side representatives have advocated a more targeted approach than model terms.

6.87 The debate over contractual terms has been ongoing for some time, although it has recently intensified following the implementation of the Markets in Financial Instruments Directive (MiFID) and the Lehman default. It is encouraging that both parties agree that the lack of contractual certainty is undesirable, and are taking steps to tackle it.

6.88 To the extent this disagreement may impact on contractual certainty in the event of a default, the Government is keen to see a resolution. The Government will monitor market action on uncertainties in contractual terms between investment firms and investment managers, and will return to the issue at the time of the next document if necessary.

Question 78

Do you believe that Government action is required to address contractual terms issues?

Question 79

If you do believe regulation or legislation to address terms of business between investment firms and investment manager is required, which issues do you think are the highest priority? Which types of measures would best address them?

Summary of proposals

This chapter sets out a number of proposals to ensure clarity and certainty for market participants, while protecting choice. The key proposals discussed in this chapter are:

- Extension of protections similar to those afforded by Part 7 of the Companies Act, 1989, to enable Multilateral Trading Facilities (MTFs) to deal centrally with a default, without risk of challenge from the insolvency practitioner.
- A market Protocol to address absence of default terms for some OTC cash equities trades, with regulatory action if necessary.
- Introduction of an explicit requirement that CCPs offer facilities for members to segregate their business.
- Introduction of a requirement for investment firms to offer facilities to segregate client business.
- Action by Euroclear UK and Ireland (EUI), operators of CREST, to freeze pending settlement instructions in relation to an insolvent CREST participant, giving greater certainty to CREST participants as to what will happen to unsettled settlement instructions.
- Market action to address uncertainties about aspects of the contractual terms under which investment firms and investment managers conduct business.

7 Managing complex creditor positions

7.1 As indicated in Chapter 1, the Government is looking at whether unsecured creditors of investment firms may be at a disproportionate disadvantage following a firm's failure. This could occur either as a consequence of difficulties in managing the inherent complexity of the failing firm or, potentially, through externalities created by actions proposed elsewhere in this paper, particularly through the special administration regime considered in Chapter 2.

7.2 The Government believes there is a case for policy action in this area only where general unsecured creditors of an insolvent investment firm (see Box 7.A) are at a disadvantage compared to unsecured creditors of other types of firms. In addressing this issue, the Government presents policies which are designed to allow:

- unsecured creditors of investment firms to be protected against disproportionate destruction of value in the event of the firm's insolvency;
- outcomes for general creditors to be balanced against those for clients, counterparties, and the public interest, mitigating negative externalities to the greatest extent possible;
- for certainty and speed for the amounts that could be recovered for unsecured creditors; and
- investors to have confidence in providing unsecured debt financing to investment firms in the UK.

7.3 Based on discussions with the Advisory Panel, the Government believes that the extent of value destroyed for unsecured creditors during the insolvency of an investment firm is broadly commensurate with that involved in the failure of other types of firms. However, there are some discrete factors that may need to be addressed, which may otherwise cause the insolvent estate, and therefore its unsecured creditors, to face significant losses. These include:

- uncertainty around the timing of counterparty terminations and close out valuations in derivatives agreements. The Government is of the view that the market should move towards incorporating a defined period for termination within these contracts. It will monitor developments closely and may consider applying bar dates for termination of derivatives contracts, should it be considered necessary.
- difficulties faced by administrators in managing trading book risk exposures of a failed investment firm. The Government proposes to provide administrators with a range of options to engage risk managers and focus on risk management under administration, through a resource centre as outlined below.
- challenges around managing repo-market close-outs effectively.

7.4 In addition to these factors, the loss of market confidence has a particularly strong impact on financial firms, which means that the failure of such a firm is likely to have a greater impact on its unsecured creditors than those of non-financial firms. The Government notes that the issue of broader impacts on unsecured creditors is a highly complex issue, and will continue to monitor potential impacts carefully.

Box 7.A: Unsecured creditors of investment firms

A significant proportion of the balance sheet of a typical investment bank consists of collateralised relationships, including collateralised derivative contracts, repurchase ('repo') and reverse repurchase agreements, and securities borrowing and lending agreements.

On the other hand, the principal unsecured creditors of an investment firm are typically:

- investors in fixed income debt instruments of the firm, including bonds, commercial paper and other debt instruments;
- clients, typically hedge funds that have placed assets with the firm and where these assets have been rehypothecated (the client stands as a general creditor for the return of these assets in an insolvency);
- clients who have placed cash with the firm in a prime brokerage context or other context (for example, margin for futures business) where this cash is not subject to segregation protection;
- clients or counterparties of the firm that have entered into unsecured agreements with the bank, which provide for the termination of derivative contracts and securities transactions that are due but not yet settled; and
- clients or counterparties of the firm that have entered into secured contracts where the amount of collateral is less than the amount owed to them by the investment firm; this may be because collateral is only exchanged once the credit exposure exceeds a fixed amount.

Termination of derivatives contracts

7.5 A major investment firm will typically have a large number of substantial, complex derivatives positions and financing contracts in the market. Concerns for unsecured creditors with respect to derivatives positions when an investment firm goes into insolvency, addressed in turn below, might relate to uncertainty about when non-defaulting counterparties to the failed firm's derivatives positions might terminate positions and difficulties with close-out valuation for derivatives contracts.

7.6 Over-the-counter (OTC) derivatives positions are generally governed by standard Master Agreements such as those developed by the International Swaps and Derivatives Association (ISDA). The ISDA Master Agreement covers the vast majority of OTC derivatives transactions in the UK market. Out of these, most transactions are still covered by ISDA's 1992 Master Agreement, but the market is increasingly moving towards the 2002 Master Agreement.[29]

7.7 The ISDA Master Agreement provides that the obligations of a party under each transaction under the Master Agreement are conditioned upon the other party not defaulting. This condition precedent is set out in section 2(a)(iii) of the Master Agreement. The Master

[29] Anecdotal evidence also suggests that a considerable number of 1992 ISDA Master Agreements have been amended to use the close-out methodology of the 2002 ISDA Master Agreement. In August 2008, most major dealers signed a multilateral agreement to effect such an amendment with the other major dealers, various Lehman entities having been among the signatories. In May 2009, ISDA opened the Close-out Amount Protocol to facilitate such an amendment among a wider group of dealers and end-users.

Agreement allows the non-defaulting party to treat the insolvency event as an event of default and gives it the right, but not the obligation, to terminate all transactions under the agreement. Contractual sections such as section 2(a)(iii) are valid under UK law, if properly drafted so as not to offend the "anti-deprivation principle".[30] Section 2(a)(iii) can be relied upon by the non-defaulting counterparty effectively to "suspend" payments to the defaulting counterparty. Although technically there is no suspension of payments due to section 2(a)(iii) the payment obligations do not arise because the condition precedent is not fulfilled.

7.8 Section 2(a)(iii) does not specify a time period within which the non-defaulting counterparty needs to decide whether or not to terminate all transactions under the ISDA Master Agreement, in effect allowing the non-defaulting counterparty to suspend its decision indefinitely and during that time not to make any ongoing payments to the failed investment firm. This is most likely to arise in practice where, on a termination, a net close-out payment would be owed by the non-defaulting counterparty to the failed firm.

7.9 Market participants have indicated to the Government that section 2(a)(iii), which was first included in the 1987 version of the ISDA Master Agreement, provides an important protection for the non-defaulting counterparty in the initial period after a party has defaulted, so that it is not required, for example, to make payments, and therefore increase its potential credit loss, to a defaulting party or to close out prematurely. At the same time, it was never intended to operate as a 'walk-away' clause and, until the recent financial crisis, it was normally assumed that the non-defaulting counterparty would, in virtually all cases, eventually terminate and close-out the outstanding positions.

7.10 Recent events have demonstrated that administrators might need to continue to administer trading positions under outstanding transactions and to monitor the related risks, subject to substantial uncertainty regarding if and when the counterparties to those open transactions will terminate. It is difficult for the administrators to manage the risks associated with those trading positions under such circumstances.

7.11 Although the administration could potentially benefit from the eventual termination of transactions under an ISDA Master Agreement, the longer the positions are outstanding, the harder it is to quantify this benefit. The administrator could also incur losses on those transactions over time (relative to a comparatively early realisation of its net credit position under such an ISDA Master Agreement) due to practical difficulties in establishing and maintaining effective hedge positions while the firm is in administration. Over time, this could damage the value of the estate, thereby affecting the level of return available for unsecured creditors.

7.12 The Government has considered several options to deal with the time period over which counterparties to OTC derivatives transactions with the failed investment firm need to exercise their termination rights, while at the same time ensuring fairness to the non-defaulting counterparties. These include legislating to require automatic termination of all derivatives transactions upon administration or termination of contracts by counterparties within a certain period (bar dates on counterparty claims) and encouraging the market to develop a solution that preserves any perceived benefit of section 2(a)(iii) while providing sufficient certainty to the administrators as to the eventual timing of early termination and therefore realisation of the value of open transactions.

7.13 The Government hopes that a market solution can be reached and would support proposals to enable a greater degree of certainty with respect to derivatives transaction terminations. Market participants are engaged in discussions on section 2(a)(iii) of the ISDA

[30] The anti-deprivation principle is a long-standing principle of UK insolvency law which invalidates a contractual clause that deprives a party of an asset upon its entry into insolvency proceedings

Master Agreement, especially in light of the recent US Bankruptcy Court ruling on the same. The Government is monitoring developments in this area and will encourage ISDA to consult with its members to develop an appropriate solution to the issues noted above.

7.14 Any such market solution should preserve the necessary flexibility for the solvent counterparty to decide whether to terminate transactions in an orderly and commercially reasonable way, so that the solvent counterparty can manage its own risk effectively (and therefore minimise the systemic risk impact of such close-outs). It should also provide certainty to administrators that the termination of all outstanding OTC derivatives positions will occur within a reasonable period. The Government is not ruling out further intervention (such as requiring bar dates) should the market fail to reach an adequate solution.

Question 80

Do you agree that regulatory or legislative action is not required if a suitable market solution is reached with respect to the issue of terminating derivatives contracts as set out above? Do you have views on what type of regulatory or legislative action will be most appropriate should there be no market solution to this issue?

Close-out valuations

7.15 There may be other concerns regarding the use of derivatives Master Agreements, such as the potential for disagreement between the parties on close-out valuations. Close-out valuation rules under the latest ISDA Master Agreement are clear, and provide administrators with several levers to challenge counterparty valuations. Where value can be lost for the insolvent estate, and therefore for unsecured creditors, is through the lack of valuation expertise and/or relevant market data under an investment firm's administration. Without access to the relevant skilled resources and market data, administrators may find it difficult to determine the reasonableness of close-out valuations provided by counterparties. The Government addresses the issue of difficulties with risk management and valuation resources for administrators further below.

Box 7.B: Close-out valuations under the ISDA Master Agreement

Close-out valuations are based generally on either market quotes for the contract where such information is available, or on loss calculations based on the 'commercial reasonableness' of the valuation. Under the 1992 ISDA Master Agreement, counterparties could start directly with the method of loss calculation, which could lead to valuations significantly different from the administrator's own internal calculations. This in turn could delay close-outs due to disagreements between parties. The 2002 Master Agreement addresses this concern by replacing the different close-out valuation approaches by a single approach (the Close-out Amount).

Most LBIE contracts were under the 1992 Master Agreement, creating problems for administrators. Market participants are increasingly choosing either to modify the 1992 agreement to incorporate an updated close-out clause or to switch over completely to the 2002 Agreement, depending on their flexibility requirements. This has largely occurred through signing of protocols. The Government understands that where new close-out valuation rules were used, close-outs have occurred more or less smoothly.

Managing trading book risk

7.16 Apart from uncertainty arising out of contract terminations, risk exposures can cause problems for the unsecured estate and could lead to significant destruction of value if trading book risks are not managed actively. Investment firms spend a significant amount on risk management, deploying specialised resources and dedicated IT systems. However, administrators might not be in a position to provide the same degree of focus on risk management due to: (a) the focus of the administration process on certainty and asset recovery; and (b) practical difficulties in bringing the right resources to bear.

7.17 Risk management requires a distinct set of skills and experience. While administrators have access to highly skilled resources from within their own firms, these may not always be sufficient to manage an investment firm's trading positions fully effectively.

7.18 In addition, administrators are likely to face practical obstacles to trading on behalf of the failed firm; market infrastructure providers may withdraw their services post insolvency, or administrators may not have adequate financial resources to trade. Another practical difficulty administrators may face that further limits their ability to monitor and manage risk, is the lack of access to the investment firm's data and IT systems.

7.19 The Government has considered several policy options to assist with risk management in the event of the administration of an investment firm. Some of the policies considered in Chapters 2 and 3, would not only provide effective resolution for clients, counterparties and the market in general but also facilitate risk management by addressing the difficulties identified in this chapter, including through amendments to personal liability for administrators, for example.

7.20 In addition, the Government is considering setting up a resource centre to provide support for administrators of failed investment firms. This would establish best practice and provide a pool of resources that administrators could draw upon to help actively manage the risk book of a failed firm.

7.21 The resource centre could be "virtual" and could be standalone or housed within the FSA. The latter would allow FSA resources to be utilised optimally, and would enable close contact between administrators and the Authorities; this could also potentially minimise costs. The centre could provide the following kinds of support to administrators:

- a basic framework for an "Operating Model" of an investment firm under administration, outlining activity areas, workstreams and processes. This could highlight the importance of risk management functions. The administration of a large investment firm requires multiple inter-related and overlapping workstreams operating simultaneously. An effective model needs to be in place to ensure that these complexities are dealt with efficiently;
- resources and information on valuing illiquid securities and derivatives, for example, a repository of market data on securities and contracts over a period of time. One of the challenges facing the LBIE administration is the lack of access to market data that goes sufficiently back in time to aid valuation.[31] Such a repository could also be put to other commercial uses when not being used for the administration of an investment firm;

[31] PWC Joint Administrators Report, for the period 15 September 2008 to 14 March 2009 April 2009
http://www.pwc.co.uk/pdf/LBIE_progress_report_140409.pdf]

- methods and basic principles for reconciling complex claims, with an emphasis on dealing with the multiple relationships of an entity with an investment firm; for example, client, secured counterparty, unsecured creditor;
- a protocol framework for agreements with market infrastructure providers and affiliates;
- other lessons from previous insolvencies such as the LBIE administration; and
- a list of approved risk managers who the administrators could appoint to be engaged in the administration process. The rationale for this is described below.

7.22 With respect to the last point, the Government and the Advisory Panel considered ways in which the administrators could be given access to risk managers with the appropriate skills. A combination of policy tools would provide administrators with the option to bring either risk managers from outside the investment firm or to make use of an in-house risk management expert who would be ready to act in the event of insolvency. The latter could be part of the "key staff" specified by the firm within its business information pack.

7.23 The resource centre described above could hold an updated list of approved risk managers from outside the firm, ready to take up employment within the administration process should the administrators require them to do so. These could be retired risk managers willing to be involved with the administration process or risk managers employed by other investment firms. However, appointing the latter could lead to conflicts of interest. In either case, potential risk managers for the administration process could be required to run simulations of crisis management to build their expertise.

Question 81

Do you agree with the proposal for a resource centre to aid administrators of investment firms?

Repo-market close-outs

7.24 During the financial crisis, large banks and investment firms found it difficult to depend on repo financing to meet their obligations due to increasing repo rates and "haircuts " in the repo markets and the refusal by lenders to accept some kinds of securities as collateral. Repo counterparties required higher haircuts or margins from firms facing liquidity problems to account for uncertainty related to the value of collateral.

7.25 In terms of the value recovered for general creditors of an investment firm, there may be a case for policy action to deal with value trapped with clearing banks or repo counterparties if they hold on to 'excess' collateral from a defaulting investment firm.

7.26 Repo collateral is held by either a tri-party clearing bank, or directly by the lending counterparty if there is no third-party clearing. If the borrowing investment firm is unable to repay the cash to the clearing bank or cash lender, then the counterparty would need to sell the collateral to recover its cash. The repo counterparty would then need to return any cash over and above what was owed to it by the investment firm (i.e. 'excess' collateral or cash) back to the defaulting investment firm.

7.27 However, if the counterparty finds it difficult to sell the collateral or there is significant disagreement between the counterparty and administrators on close-out values, it may result in the counterparty holding on to the excess collateral if any, which means that the insolvent investment firm's estate could be losing value. The value of repo market collateral can potentially be significant in the case of investment firms and the excess held with the repo counterparty has the potential to affect the returns to unsecured creditors substantially. The Government is considering the extent to which this issue needs to be addressed, and what possible steps may need to be taken.

Question 82

Do you have views on the difficulties that repo market transactions could pose for the insolvency of an investment firm, affecting value recovered for creditors? If this is a concern, what kind of policy action could the Government consider to address it?

Mitigating negative externalities

7.28 In developing policy options specific to counterparties and clients, the Government has considered the possibility of negative externalities for unsecured creditors and sought to mitigate these to the greatest extent possible. In general, policies in relation to counterparties and clients aim to attain swifter, more certain outcomes for these parties, and not to change the distribution of outcomes. However, there are some areas where externalities may occur for unsecured creditors, and these are discussed below.

- Establishing a client assets agency or client assets trustee could potentially have an impact on unsecured creditors. It could be argued that by transferring the power of administrators over client assets to a new body (and by requiring administrators to prioritise co-operation with the same), the size of the potential pool of assets for unsecured creditors may be reduced.
- Changes to the regime around set-off and liens may have an effect to the extent that set off and liens removed from client assets, in regards to debts the investment firm owes in a principal capacity, could lead to the investment firm having to pay costs from the general estate.
- Part 7 of the Companies Act 1989 provides a number of protections for action taken by a recognised investment exchange or clearing house under its default rules or to enforce default fund contributions or property provided as margin by a member of the exchange or clearing house who has gone into insolvency proceedings. Effectively, it permits the default rules of an exchange or clearing house to take precedence over certain insolvency law provisions so to allow the exchange or clearing house to use the collateral it holds to deal with default without risk of challenge from the insolvency practitioner appointed over the estate of the insolvent member.
- In this document, the Government discusses two areas in which there may be a case for possible extension of Part 7 type protection; in relation to multilateral trading facilities, and client underlying trades, respectively. In both cases, the Government is aware that there may be implications for the general creditors of the insolvent entity. It will bear in mind the need not to unduly disadvantage general creditors in taking any decisions on these issues, and asks for views, including quantitative information, on the potential impact of such changes on all stakeholders.

7.29 The Government believes that the policies discussed above are in general sound, and when developing these further, will try to balance outcomes for unsecured creditors, clients and counterparties of the investment firm, as well as for overall financial stability.

Cost-benefit analysis

As the proposals around the termination of derivatives contracts are potential market measures that are subject to future market views, costs have not been calculated.

The costs to market participants of a resource centre to provide for support to administrators of investment firms are considered by the Government to be negligible.

Question 83

In relation to the areas listed here, are there any concerns that would substantially change the distribution of the outcome? Are there any other areas not covered here that may create negative externalities for unsecured creditors?

Question 84

Are there any specific factors with respect to the loss of market confidence and complexity of business that affect unsecured creditors, which are not addressed here and which the Government should consider?

Summary of proposals

This chapter discusses the significance of the issues faced by unsecured creditors following the collapse of an investment firm like LBIE. It also outlines the Government's objectives to mitigate the impacts of future investment firm failure on unsecured creditors, and to retain sufficient confidence in the system to allow institutions to continue to provide unsecured debt financing.

The proposals explained in this chapter around the termination of derivatives contracts and the Resource Centre for administrators aim to provide: certainty for creditors; a reasonable time period for the recovery of creditor claims; and ensuring sufficient confidence for unsecured investors to continue lending to investment firms.

8 Working towards cross-border resolution

8.1 The Government recognises that the business and operations of a large investment firm are likely to be part of an international group. This group may or may not be headquartered in the UK. Where a group is based in an overseas jurisdiction, it may be subject to different regulatory and insolvency laws.

8.2 Such a firm is also likely to use custodians and sub-custodians located in other jurisdictions. At the time of failure, it is possible that these custodians may be subject to their own insolvency or pre-insolvency processes. It is therefore necessary to consider UK solutions for a failing investment firm in an international context. In particular, the Government is considering:

- the recognition (or otherwise) of any UK solutions in other jurisdictions;
- the interrelationship between UK insolvency or pre-insolvency proceedings and those in other jurisdictions; and
- mechanisms that may be used on a cross-border basis.

8.3 There is a clear need for international cooperation on these issues. To this end, the Government will develop coherent proposals for the UK regime, and will seek to encourage interoperability with initiatives being undertaken by the European Commission and the US (see Box 8A and Box 8B).

Box 8.A: European Commission - Areas of financial supervision reform

The European Commission issued a Communication on a European Union framework for crisis management in the banking sector[32]. The Communication discusses what measures are needed and how national actions can be coordinated or integrated when applied to a cross-border group.

The Communication considers measures ranging from "early intervention" action by banking supervisors aimed at correcting irregularities at banks, to bank resolution measures which involve the reorganisation of ailing banks and to insolvency frameworks under which failed banks are wound up.

The 2008 Memorandum of Understanding on Financial Stability also sets out, at a high level, common principles for crisis management in the European Union. The European Council is seeking to strengthen supervisory coordination by setting up the European Systemic Risk Board and European System of Financial Supervision, and has invited the Economic and Financial Committee, together with the Commission, to develop practical arrangements for improving European Union-wide policy coordination.

[32] http://ec.europa.eu/internal_market/bank/docs/crisis-management/091020_communication_en.pdf

Box 8.B: US - Areas of financial supervision reform

In proposals published in June 2009,[33] the US Treasury identified several areas where it believes it can improve its existing regulatory and resolution framework. One element involves the establishment of a new special resolution process that allows the US Government to resolve in an orderly way any failing financial institution that threatens the entire financial system. This involves creating a process for imposing losses on the firm's shareholders and creditors, ensuring that the financial industry, not taxpayers, ultimately bears any additional costs associated with the resolution process.

This special resolution process would allow the US Government to sell assets, liabilities, and business units of the firm; transfer the systemically significant operations of the firm to a new bridge entity that can continue these operations with minimal disruptions and repudiate contracts of the firm, subject to appropriate recompense.

Many of these proposals were included in the Financial Stability Improvement Bill,[34] which was published on 27th October 2009 and has been introduced into the House of Representatives. A separate bill has been introduced into the Senate.[35] This proposes a rather different regulatory structure. However, its provisions relating to the resolution of non-bank financial institutions are broadly comparable with the House of Representatives bill.

Existing initiatives for international cooperation

8.4 A firm that conducts investment business is not covered by any European cross-border insolvency legislation unless it also has a deposit-taking business. The European Commission Regulation on Insolvency Proceedings (EC) No 1346/2000 excludes investment undertakings that provide services involving the holding of funds or securities for third parties (art 1(2)). The Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions applies to authorised deposit-taking institutions. It therefore includes in scope those firms which carry out investment business.

8.5 At present, there is no cross-border framework across the European Union or European Economic Area which provides for the automatic recognition of certain types of insolvency proceedings commenced in the 'home' member state (i.e. the principal place of authorisation of the investment undertaking).

8.6 Instead, any insolvency officeholder appointed in relation to an investment firm in the UK would have to seek recognition of the UK proceedings in other relevant jurisdictions (as the administrators of LBIE have done in France). It is then a matter for the discretion of the overseas court as to whether such recognition is granted. There is also nothing to prevent parallel or ancillary insolvency proceedings being commenced, in relation to a UK-authorised investment firm, in another jurisdiction, which could clearly lead to cross-border complexities.

8.7 Whilst any solutions the Government takes forward will be limited to UK authorised investment firms, the Government will monitor any relevant cross-border initiatives, and engage in them where appropriate. It will seek to ensure proposed UK solutions are consistent with international developments, such as those proposed by UNCITRAL, UNIDROIT, CESR, FSB, and the CBRG. Explanations follow of the functions of these bodies in this area.

[33] http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

[34] http://www.house.gov/apps/list/speech/financialsvcs_dem/committee_print_titlei102904.pdf

[35] http://banking.senate.gov/public/_files/AYO09D44_xml.pdf

United Nations Commission on International Trade Law (UNCITRAL)

8.8 UNCITRAL is the core legal body of the United Nations system in the field of international trade law. UNCITRAL's focus is the modernisation and harmonisation of rules on international business. The Government is aware that an investment firm may be covered by a particular jurisdiction's implementation of the UNCITRAL Model Law on Cross-Border Insolvency. The objectives of UNCITRAL's Model Law on Cross-Border Insolvency are set out in Box 8C.

8.9 To date, only a limited number of European jurisdictions have implemented this law, which does not provide for the automatic recognition of all aspects of the insolvency proceedings in question.

Box 8.C: Objectives of UNCITRAL Model Law on Cross-Border Insolvency

- Cooperation between the courts and other competent Authorities of states involved in cases of cross-border insolvency.
- Greater legal certainty for trade and investment.
- Fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested persons, including the debtor.
- Protection and maximisation of the value of the debtor's assets.
- Facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

International Institute for the Unification of Private Law (UNIDROIT)

8.10 UNIDROIT is an independent inter-governmental organisation. Its purpose is to study needs and methods for modernising, harmonising and coordinating private and in particular commercial law as between States and groups of States.

8.11 The Government recognises the need to ensure clarity over the treatment of securities held through an intermediary and therefore supports the Convention on Substantive Rules for Intermediated Securities adopted by UNIDROIT (now known as the "Geneva Securities Convention"). The main issues addressed by the Geneva Securities Convention are set out in Box 8.D and are a welcome step to ensuring legal clarity in respect of interests in intermediated securities.

8.12 The Government notes that the European Commission has announced that it is also proposing a European Union-wide legal framework for the holding and disposing of intermediated securities, and for the safekeeping and administering of such securities.

Box 8.D: Issues addressed by the Geneva Securities Convention

- Clarifies the rights of an account holder and obligations of a securities account provider resulting from the credit of securities to a securities account.
- Establishes methods to transfer intermediated securities and to establish security and other limited interest therein that must be recognised as legally enforceable in a Contracting State.
- Clarifies the rules regarding the irrevocability of instructions to make book entries and the finality of the resulting book entries.
- Precludes "upper-tier attachment" i.e. claims made against an intermediary higher in the chain of ownership.
- Establishes a priority ranking among competing interests with respect to securities.
- Protects the innocent ("good faith") acquirer of securities from adverse claims;
- Sets out the rights of the account holder and the responsibilities of the intermediary in the event of insolvency.
- Establishes a regime for loss allocation.

Committee of European Securities Regulators (CESR)

8.13 The role of CESR is to improve coordination among securities regulators, develop effective operational network mechanisms to enhance day-to-day consistent supervision and enforcement of the Single Market for financial services, and act as an advisory group to assist the European Commission. In particular, it will assist the Commission in its preparation of draft implementing measures of European Union framework directives in the field of securities.

8.14 The Government notes that CESR is due shortly to receive a mandate from the European Commission to provide technical advice on a mandatory review of certain MiFID provisions. The Government would welcome any initiatives arising from this review which address issues raised in this document over the continuity of cross-border services. It sees the review as a potentially important mechanism for dealing with concerns in this area.

Basel Committee's Cross-Border Bank Resolution Group (CBRG)

8.15 The CBRG has carried out a considerable amount of work comparing the national policies, legal frameworks and the allocation of responsibilities for the resolution of banks with significant cross-border operations. The Government supports the findings of the CBRG in its September 2009 Consultation paper *Report and Recommendations of the Cross-border Bank Resolution Group*[36]. The recommendations made by the CBRG are set out in Box 8E and provide a sound framework for resolution and cross-border cooperation.

[36] http://www.bis.org/publ/bcbs162.pdf?noframes=1

Box 8.E: Recommendations from the 2009 CBRG consultation paper

- National Authorities should have appropriate tools to deal with all types of financial institutions in difficulties through orderly resolutions.
- Each jurisdiction should establish a national framework to coordinate the resolution of the legal entities of financial groups within its jurisdiction.
- National Authorities should seek convergence of national and international resolution tools and measures.
- National Authorities should consider the development of procedures to facilitate the mutual recognition of crisis management and resolution proceedings measures.
- National Authorities should consider imposing regulatory incentives to encourage appropriate simplification of complex investment firm structures.
- All systemically important cross-border financial institutions should produce and regularly maintain recovery and resolution plans.
- Key home and host state Authorities should agree, consistent with national law and policy, on arrangements that ensure the timely production and sharing of key information.
- Jurisdictions should promote the use of mitigation techniques that reduce systemic risk.
- National Authorities should have legal authority to delay temporarily the immediate operation of contractual termination.
- In order to restore market discipline, national Authorities should consider and incorporate for the exit from public intervention into their planning.

Financial Stability Board (FSB)

8.16 In March 2009, the Financial Stability Forum (which has since become the Financial Stability Board) agreed on a set of high-level principles for cross-border cooperation on crisis management. The G20 Leaders have called for the immediate implementation of the principles. Amongst other things, the principles commit the Authorities of the world's largest cross-border banks to come together, at least annually, to discuss crisis management arrangements for those firms. Such firm-specific "crisis management groups" will discuss the potential practical barriers to resolving issues and try to find solutions to them, or refer the problem to other cross-border committees or groups as necessary. The FSB will also scrutinise the contingency and resolution plans produced by the banks.

8.17 It is worth noting that the UK is taking a leading role internationally in developing proposals for recovery and resolution plans (RRPs). As well as the provisions set out in the Financial Services Bill in respect of RRPs, the FSA outlined its position regarding the form and content of RRPs in its October Discussion Paper[37] addressing systemically important banks. The

[37] http://www.fsa.gov.uk/pubs/discussion/dp09_04.pdf

findings of its RRP pilot project, due for completion in 2010, will contribute to the development of RRP standards both in the UK and internationally through the FSB. The FSA will be conducting a full impact assessment and cost-benefit analysis, subject to consultation, before issuing its draft rules on RRPs.

8.18 The Government appreciates the importance of international consensus regarding RRPs, given potential concerns relating to the competitive position of UK firms and regulatory arbitrage. The Government believes this is consistent with the UK taking the lead in developing policies on RRPs. International RRP policy needs to be consistent with individual jurisdictions' resolution frameworks, and international work developments will be informed by the pilot work being undertaken by the FSA. Legislative provisions on RRPs require the FSA to consider international standards as they develop.

8.19 The FSF Principles for Cross Border Cooperation in Crisis Management may be accessed through the following website: http://www.financialstabilityboard.org/publications/r_0904c.pdf

Encouraging cross-border cooperation

8.20 The Government recognises that any measures put forward in this paper to mitigate the effects of an insolvent systemic investment firm would be substantially aided by cross-border cooperation, as such firms typically operate on a cross-border basis.

8.21 The Government therefore supports the idea that for EU firms there should, to the extent permitted by European Union law, be interoperability between resolution regimes for investment firms that operate in different jurisdictions. This cross-border cooperation should follow the principles of being:

- reciprocal;
- mutually beneficial;
- time and cost effective; and
- consistent with international agreements and safeguards.

8.22 One option for cross-border cooperation is the development of procedures to facilitate the mutual recognition of crisis management and resolution proceedings. The Government notes that CESR has consulted on the issue of mutual recognition in its paper *Call for evidence on mutual recognition with non-European Union jurisdictions,* which suggested three possible options for mutual recognition:

- standardisation – the development of common approaches or international standards;
- exemptions – providing exemptions from national rules to foreign entities where imposing such rules would be disproportionately burdensome; and
- recognition – accepting compliance by a foreign entity with its home country standards through mutual recognition.

8.23 The Government welcomes the work being conducted by CESR in this area and will continue to support these initiatives. As highlighted earlier in Box 8.E, CBRG has set out multilateral procedures that could allow for recognition of foreign representatives and foreign crisis management and resolution proceedings and/or measures, subject to defined legal, public policy or other limitations.

8.24 An important procedural example, highlighted by CBRG, would be to adopt steps specifying the grounds under which one jurisdiction would recognise the transfer of ownership or property from a failing financial institution directly to a private firm, to a national insolvency authority, or to a bridge financial institution or another public entity. Mutual recognition could also extend to substantive decisions on claims and other resolution decisions. The Government is keen to support these initiatives and believes that mutual recognition could, provided that there are the appropriate safeguards, help resolve the issues that arise from the insolvency of large international investments firms.

Summary of proposals

This chapter has set out the UK Government's aim to pursue cross-border solutions and has discussed the steps other key jurisdictions are considering to mitigate the failure of a systemically important firm. It has also highlighted the latest developments by UNIDROIT, UNCITRAL, CESR, CBRG, and the FSB in relation to the harmonisation of investment business activities, RRPs, and cross-border resolution.

The Government accepts the need for cross-border cooperation to address the failure of a systemically important firm. It will consider the measures required to achieve this; for example, by seeking the mutual recognition of international regimes that have similar safeguards and resolution tools as the UK.

A Summary of proposals

Table A.A: Summary of proposals

Proposal number	Para Ref	Description
Enabling an orderly resolution: Chapter 2 sets out proposals for a new administration regime for a failed investment firm. This would ensure that the administration of a failed firm is conducted with due regard to financial stability and the proper functioning of markets, as well as with reference to the need for the speedy recovery of assets for clients, and the reconciliation of counterparty positions.		
1.	2.13	Special administration objectives (SAOs): which will aim to provide precedence to certain activities that administrators would have to focus on.
2.	2.25	Changes around administrator liability: special defence against liability for insolvency practitioners for acting according to the SAOs for investment firms.
3.	2.41	Modification to insolvency legislation around directors' liability: special defence against liability for directors of investment firms, for actions under the investment firm resolution plans, in consultation with the FSA.
4.	2.56	Explore obstacles to the provision of intra day funding: by third parties to investment firms in the UK prior to, and following, the firm's insolvency.
5.	2.62	Develop effective communication plans: planning by the Authorities for appropriate practical and coordinated communication when an investment firm fails.
Requiring firms to manage for failure: Chapter 3 sets out proposals for new regulatory requirements, under which firms will play a leading role in managing for their own failure.		
6.	3.13	Business resolution officers: officers at the Board level, with delegated responsibility to coordinate and implement firm-level resolution actions.
7.	3.22	Investment firm resolution plans: resolution plans including internal actions by the firm followed by market-facing resolution actions immediately prior to insolvency
8.	3.28	Business information packs: contemporaneous and accurate repositories of information for administrators to use in the event of the investment firm's insolvency.
9.	3.44	Continuity of key services: key staff and supplier contracts to provide continuity of services following insolvency.
10.	3.73	Operational reserve: a reserve of adequate liquid funds that administrators can use in the event of insolvency to pay key staff and suppliers to continue their services post-insolvency for a period of 90 days.
Reconciling and returning client property: Chapter 4 sets out proposals to improve outcomes for the clients of a failed investment firm. Clients are particularly affected, since their assets and money, to which they have a proprietary claim, can become trapped in the failed estate. It is important for the proper functioning of the market that such assets can be released to their beneficial owners as quickly as possible. This chapter also sets out proposals to improve the protections for investment firm clients at a pre-insolvency stage.		

Proposal number	Para Ref	Description
11.	4.13	Increase clarity over the allocation of shortfalls in an omnibus account: clarifying the treatment of client assets on insolvency by making the allocation of shortfalls in a client asset omnibus account pro rata.
12.	4.13	Mandate product warnings in contractual agreements: clearly setting out the implications of allowing rehypothecation and use of client omnibus accounts at custodians.
13.	4.13	Encourage clarity in contractual agreements: by encouraging investment firms to be transparent over any risks to client money and assets protection.
14.	4.47	Increase reporting and record-keeping requirements: requiring investment firms to develop capacity for daily reconciliation of client positions and exposures.
15.	4.47	Increase audited disclosures by firms around client money and assets: increasing disclosures by firms to the FSA around the holding of client money and assets.
16.	4.47	Make client asset officers directly accountable: clarifying controlled function 29, so that FSA is able to ensure that the people in charge of directing client assets are fully qualified and capable of executing their duties.
17.	4.61	Support the establishment of bankruptcy-remote SPVs for client assets: to ensure that the return of client assets is not affected by the insolvency proceedings of the investment firm.
18.	4.61	Substantial limitations on the transfer of client money: placing an absolute ban or heavy limitations on the ability of investment firms to transfer client money to affiliate entities and jurisdictions where there potentially are interoperability issues with CASS protections.
19.	4.61	Change the regime regarding custodians' right of lien over client assets: firms would be required to obtain letters in respect of client assets that state that the custodian has no lien or right of retention over the account and that it will not seek to combine, net, or set off the account against the debts or obligations of the firm.
20.	4.61	Require firms to have the ability to divide client money into different pools: client money might be divided into different pools according to the type of investment involved.
21.	4.61	Establish bar dates for client claims: create a statutory scheme with fixed terms under which client claims have to be received and dispersals commenced.
Providing clear and effective support for clients: Building on the proposals in Chapter 4, Chapter 5 sets out the Government's proposals for the possible creation of a client assets agency and the position of a client assets trustee. A trustee would have a role separate to the administrator of a firm in insolvency and would be tasked with prioritising the return of client assets and money.		
22.	5.2	Establish a client assets trustee: to prioritise the return of client money and assets post-insolvency.
23.	5.2	Establish a client assets agency: to monitor pre-insolvency best practice in the treatment of client money and assets.
Reconciling counterparty positions: Chapter 6 sets out proposals to mitigate the impact of investment firm failure on the market counterparties of the firm. The proposals in this chapter are designed to improve the functioning of market infrastructure in the event of an investment banking failure. The key proposals discussed in this chapter are:		

Proposal number	Para Ref	Description
24.	6.21	Extend protections similar to those of Part 7 of the Companies Act 1989, to MTFs.
25.	6.38	Monitor the development of the market Protocol for OTC cash equity trades: assess suitability of uptake, scope and terms.
26.	6.60	Explicit requirement that CCPs offer facilities for their members to segregate client business.
27.	6.64	Consider requirement that investment firms offer facilities to segregate client business: to ensure a choice of accounts for clients.
28.	6.78	Monitor the development of EUI proposal to prevent uncertainty of settlement in future: by freezing pending instructions relating to an insolvent entity.
29.	6.88	Monitor market action on uncertainties in contractual terms between investment firms and clients:
Managing complex creditor positions: The Government recognises that all of the proposals outlined in this document need to be considered in their broader context, both in terms of their impacts on the general unsecured creditors of the failed estate, and in terms of how the actions proposed will interact with steps taken in other jurisdictions. Chapter 7 considers the impacts of the policies outlined above on the unsecured creditors of a failed firm. It also discusses possible changes to the International Swaps and Derivatives		
30.	7.13	Support proposals to enable a greater degree of certainty with respect to derivatives transaction terminations
31.	7.20	Set up a resource centre; providing best practice guidance to insolvency practitioners on the administration of large, complex investment firms.

Source: HM Treasury

B Summary of questions

Question number	Question
	Introduction
1.	Do you have any comments on the proposed definitions of investment firm for the purposes of this work?
	Chapter 2 - Enabling an Orderly Resolution
2.	Do you agree with the Government's proposals for special administration objectives and associated policy measures? Are there any supporting levers not considered in this document that would be critical for the effective functioning of the special objectives?
3.	What are your views on introducing a limited restriction to the liability of the administrator, restricting creditors from taking action in certain circumstances, related to administrators' actions in pursuit of the SAOs?
4.	What are your views on the suggestion that the personal liability of administrators should not be greater than that of the company's directors before the company went into insolvency?
5.	Do you agree with the Government's approach to the court process for clarification around liability? What kind of expedited court process could be considered? Should one be required?
6.	Is there any other approach the Government could consider with respect to the modification of administrator liability for the purposes of the special administration regime for investment firms?
7.	Do you agree with the Government's approach in providing a special defence for directors of investment firms against actions taken by administrators and others, to enable directors to implement resolution plan actions in the interests of the firms' creditors and of financial stability? What specific modifications could the Government consider applying?
8.	Do you agree with the proposals for the initiation and scope of the special administration regime for investment firms and its interaction with the provisions of Part 2 of the Banking Act 2009, as described in Box 2A?
9.	Is there a case for considering provisions in the special administration regime for investment firms in relation to new financing? The Government also welcomes feedback on the potential legislative or other hurdles to an investment firm obtaining additional funding from third parties in the period immediately before insolvency to close out its positions. Are there other issues or options in relation to intra-day support that the Government might need to consider?
10.	The Government considers the costs to market participants of implementing the special administration regime, with provisions for special administration objectives, liability of insolvency professionals and directors, and possible legislative changes for intra-day support to be negligible. Do you agree with the cost suggested in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.

Question number	Question
11.	The Government would welcome views on the types of communications methods market participants would prefer and the type of information they would like to receive from the Authorities in case of an investment firm failure.
12.	The Government considers the costs to market participants of a resource centre providing best practice guidance to administrators, and plans for coordinated market communication in the event of investment firm failure to be negligible, as these would require no market action. Do you agree with the cost suggested in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.
13.	Do you agree with the Government's proposal for international entities not subject to these proposals to be able to 'opt in' to the firm-level resolution regime?
14.	Are there any other specific issues in relation to cross-border investment firms, not considered here or in Chapter 8, that need to be addressed?
15.	The Government welcomes views on the extent to which the package of measures proposed in Chapters 2 and 3 will contribute to achieving the effective resolution of investment firms. Do you believe there is a case for the measures to be further enhanced by a special resolution regime for investment firms?
Chapter 3 - Requiring firms to manage for failure	
16.	Do you have views on the coverage or detail of the BRO's responsibilities as outlined here? Are these consistent or compatible with existing templates for the corporate governance structure of firms?
17.	Do you agree with the basic policy of establishing a role for business resolution officers in investment firms and do you believe that this is an effective way for the FSA to ensure that the firm implements resolution actions effectively?
18.	What are your views on the nature of appointment of the BRO? Do you agree with the Government's suggested approach for implementing this policy, for example, the role being additional to a Board member's pre-existing duties and part of the FSA's Approved Persons regime?
19.	Discussions with stakeholders indicate that the additional responsibilities of a board-level officer as a BRO would require 10-20 per cent of their time on an annual basis or £100,000 to £200,000 per annum. Do you agree with the cost suggested in the paragraph above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.
20.	Do you agree that investment firm resolution plans can consist of internal actions followed by market-facing actions as proposed above?
21.	What are the obstacles to implementing investment firm resolution plans as suggested in this paper? What policies could the Government consider to address these, if any?

Question number	Question
22.	Initial discussions with stakeholders indicate that for the prime brokerage business, initial costs of setting up investment firm resolution plans could be about £1-£3 million, with a team of about ten people from different parts of the business working on them. The prime brokerage business may incur an additional £0.5-£1 million per year for continually updating the resolution plans, with a team of three people working on them. Stakeholders have suggested that costs for the entire investment banking business, including prime brokerage, would be approximately five times the costs for the prime brokerage business mentioned above; £5-15 million one-off costs, and £2.5-£5 million annual costs. There may also be ongoing benefits to the investment banking business from having in place continually updated resolution plans. These may include, for example, increased operational efficiency from identification of interdependencies between business units. However, these are not taken into account here, as it would be challenging to estimate the effect of resolution plans separate from that of other factors. These costs will ultimately depend on the final proposals put forward by the FSA. As discussed above, the FSA will be conducting a full cost-benefit analysis of its proposals. Based on the proposals for resolution plans outlined here, do you agree with the suggested costs for the prime brokerage business?
23.	What resources do you expect the entire investment banking business of the firm to spend on resolution plan implementation? Costs would include those related to: (a) designing and setting up resolution plans in collaboration with the FSA; (b) the ongoing audit and update of resolution plans and their inclusion in the firm's corporate governance activities; and (c) the additional resources required to implement resolution plans in a distress situation, if any.
24.	Do you agree that business information packs will be useful to administrators and will fulfil the Government's objectives for a managed wind-down of investment firms?
25.	Initial discussions with stakeholders indicate that for the prime brokerage business, initial costs of setting up BIPs would be similar to those of investment firm resolution plans, at about £1-£3 million, with a team of about ten people from different parts of the business working on them. The prime brokerage business is likely to incur an additional £0.5-£1 million per year for continually updating the BIPs, with a team of three people working on them. Stakeholders have suggested that costs for the entire investment banking business, including prime brokerage, would be approximately five times the costs for the prime brokerage business mentioned above; £5-15 million one-off costs, and £2.5-£5 million annual costs. As in the case of resolution plans, there may be ongoing benefits to the investment banking business from having in place continually updated BIPs, but these are not included here. Based on the proposals for BIPs outlined here, do you agree with the suggested costs for the prime brokerage business?

Question number	Question
26.	What resources do you expect the entire investment banking business to spend on BIPs' implementation? Costs would include those related to: (a) the designing and setting up of BIPs in collaboration with the FSA; (b) the ongoing audit and update of BIPs and their inclusion in the firm's corporate governance activities; and (c) the additional resources required to supplement the BIPs in a distress situation.
27.	The Government would welcome views on what incentives and disincentives are likely to be effective and whether there are any concerns with the ones suggested above.
28.	Are there any other areas and activities for which key staff should be retained? Do you agree with the Government's proposed approach for the firms to identify key staff to be retained?
29.	What do you consider would be an appropriate measure to ensure that the fees that suppliers charge post-insolvency are not inordinately high? Do you believe the Government can take specific action in this regard?
30.	Costs associated with this policy would depend on exact conditions of contracts and the number of key staff or nature of services required. The Government recognises that cross-border groups with investment banking business may negotiate contracts with staff and service providers on a central, group-wide basis. The policy proposed here is likely to lead to additional costs for negotiating contracts specific to individual legal entities. Stakeholders consider the legal costs of renegotiating contracts for both staff and suppliers to be in the region of £40,000 to £200,000. Although it is possible that these costs are high, the Government understands that they are unlikely to be as substantial as costs of on-shoring systems and services. The cost implications of associated policy measures such as an operational reserve for the payment of staff and essential services, the BIPs and BRO are examined in the relevant policy sections. Do you agree with the cost estimates suggested above, for contractual provisions for key staff and suppliers? What are your views on the incremental costs of: (i) renegotiating contracts with vendors; (ii) putting in place appropriate contracts with key staff and (iii) creating an on-shore IT infrastructure to the extent that it is essential for wind-down in an insolvency?
31.	What alternative policy tools could be considered to ensure continuity of essential services and key staff post-insolvency? Are there any likely impacts on the competitive position of UK firms from this proposal?
32.	What are your views on legislative changes requiring administrators to use the operational reserve only for operational expenses?
33.	Initial discussions with stakeholders indicate that an operational reserve of $25-50 million would be required for the investment firm's prime brokerage business and the annual opportunity cost of such funds is likely to be about 30 to 40 basis points. In addition, the firm may need to include funds within the operational reserve for incentivising key staff to continue post insolvency. This is likely to amount to approximately $10-30 million for key staff only of the entire investment banking business of a firm. As above, the annual opportunity cost of such funds is likely to be about 30 to 40 basis points. Do you agree with the suggested cost estimates above? What is your estimate of the value of the operational reserve for the entire investment banking business of the firm, including monetary incentives for key staff, if any?
34.	Do you have any views about the operational reserve proposed in Chapter 3?

Question number	Question
Chapter 4 - Reconciling and returning client property	
35.	Should the Government look to provide clarity over how shortfalls in client asset omnibus accounts are treated on insolvency? Should the Government look to provide clarity over when clients' entitlement to their assets should be calculated?
36.	Do you agree with the Government's proposal of mandating warnings over the implications of allowing rehypothecation and omnibus accounts in relevant agreements? Should firms be required to offer clients designated named accounts at custodians?
37.	Do you agree with the Government's aim to encourage clarity in contractual agreements? If so, how is this best achieved?
38.	Initial discussions with stakeholders indicate that there would be a one-off cost of £9,000 per warning in legal costs (calculated at 30 legal hours at £300 an hour) for firms to integrate additional text around each of the following areas in standard contractual agreements: • warnings on rehypothecation; and • warnings on omnibus accounts. Do you agree with the costs suggested above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.
39.	Do you agree with the Government's proposal of increased reporting requirements for systemic investment firms? If so, are there any issues around the timing or content of reporting that the Government should consider?
40.	Do you agree with the Government's proposals for increased record-keeping requirements for investment firms? Should the Government require settlement date record-keeping, as well as trade date record-keeping on custody systems?
41.	Do you agree with the Government's support for increased audited disclosures by firms around client money and assets? Should Government require firms to make available audited client money and assets reports to clients?
42.	Should the Authorities clarify the scope of FSA CF-29 and centralise CASS oversight under one individual?
43.	Our initial discussions with stakeholders indicate that: • there could be a one-off cost of $1.5m for a firm to build a reporting system, assuming that they did not have such a system already in place. If it did have a reporting system in place, it could cost an estimated $0.5m to expand its capabilities. Ongoing maintenance of a reporting system could cost up to $2m. Record-keeping costs could be subsumed within the costs of the reporting system; • requiring firms to increase their audited disclosures could lead to ongoing annual costs of £30,000, based on 200 additional auditing hours at £150 per hour; and • there would be a negligible cost of clarifying the scope of controlled function 29. Do you agree with the above costs? If not, please provide an estimate of costs that are likely to occur, stating your assumptions.
44.	Should the Government support the establishment of bankruptcy-remote vehicles for client assets through regulatory or legislative measures? If so, how could Government provide effective support?

<table>
<tr><th>Question number</th><th>Question</th></tr>
<tr><td>45.</td><td>Do you agree with the Government's proposal of limiting the transfer of client money to affiliates, and jurisdictions where there are potentially interoperability issues with CASS?</td></tr>
<tr><td>46.</td><td>Should firms that manage client assets be required to obtain letters from custodians stating that there are no setoff and liens over client assets in respect of liabilities owed in a principal capacity by the firm?</td></tr>
<tr><td>47.</td><td>Should firms be required to have the capacity to separately pool client money relating to riskier activities?</td></tr>
<tr><td>48.</td><td>Do you agree with the Government's proposals for establishing bar dates for client claims? How should clients' rights to their money and assets be affected by a failure to summit a claim by a bar date? Should the Government impose a legal duty on an administrator or trustee to impose a bar date?</td></tr>
<tr><td>49.</td><td>Our initial discussions with stakeholders indicate that:
requiring investment firms to limit the transfer of client money to affiliates could cost around £15,000 (50 legal hours at £300 per hour) in legal costs;
there could be a one-off cost to firms of £15,000 (50 legal hours at £300 per hour) in legal costs per custodian to renegotiate their agreements over liens. Additionally there could be other charges: for example, custodians may charge a fee (a basis point charge calculated on activity) or they may require average turnover pledged on an account;
there could be a one-off cost to firms of £15,000-£1m depending on the extent to which firms already have the capability of dividing client money into different pools. There could also be an annual maintenance cost to firms of around £750,000 to maintain these separate pools; and
there would be negligible costs to clients of requiring them to submit their claims by a bar date.
Do you agree with the costs suggested above? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.</td></tr>
<tr><td>50.</td><td>Would the Government's proposals in the area of client money and assets allow sufficient flexibility to enable investors and investment firms to meet mutually acceptable outcomes? Are the proposals 'futureproof' and do they have a limited negative impact?</td></tr>
<tr><td>51.</td><td>Do you have any other views on the issue of client money and assets that you feel are important for the Government to consider?</td></tr>
<tr><td colspan="2">Chapter 5 - Providing clear and effective support For clients</td></tr>
<tr><td>52.</td><td>Do you agree with the duties and proposed scope of the CAT? Should the scope be widened to include all investment firms? Should the Insolvency Practitioner be appointed from the same insolvency practice as the administrator or from an independent firm?</td></tr>
<tr><td>53.</td><td>Do you agree with the Government's suggestions for how the CAT could be established? What do you see as the advantages and disadvantages of the two suggested legal methods of establishing a CAT?</td></tr>
<tr><td>54.</td><td>Should the costs of the CAT be funded from the client money and assets of the firm, or from the insolvent estate?</td></tr>
</table>

Question number	Question
55.	Do you agree with the proposal to establish a CAT? Should the Government favour alternative measures for improving client outcomes, such as the proposal in Chapter 2 to amend the legal duties of administrators to require them to prioritise the return of client money and assets?
56.	It is expected that any additional costs of the CAT proposal would be negligible due to the assumed faster return of client money and assets by the CAT, and the resulting fall in expected administration costs. Do you agree? If not, please provide an estimate of any costs that are likely to occur, stating your assumptions.
57.	Do you agree with the proposal that an individual from the CAA should be able to perform the CAT role, where this is desired by the regulator?
58.	Do you agree with the Government's proposal to set up a CAA? Do you agree that this should be established as a distinct body within the Financial Services Authority?
59.	Should the FSA be granted powers to sit on the creditor and/or client assets committee by right, to enable it to monitor and, if required, challenge the administrator or CAT? Should such a power include the right to vote?
60.	Should all firms currently regulated by the FSA and holding client money and assets, as defined by the FSA's CASS rules, fall within the jurisdiction of the CAA?
61.	It is expected that the FSA will allocate more resources to client asset risks in the future, to perform work that could be taken on by the CAA. The incremental costs of the CAA are therefore expected to reduce. Do you have any comment on this?
62.	Do you have any other views on the establishment of a CAT or CAA that the Government should consider?
Chapter 6 - Reconciling counterparty positions	
63.	Throughout this document, the Government is seeking stakeholder input to assess the likely costs of proposals. Preliminary work with the industry indicates that regulatory action to address incorrect TSO flagging, should it be needed, would have a negligible cost for firms, as it would simply be a matter of reiterating to staff the meaning of different flags and when they should be used. Do you agree with this assumption? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.
64.	What action should market participants take to address incorrect TSO flagging? Do you believe regulatory action to address the issue of TSO flagging is needed?
65.	What would be the advantages and disadvantages of extending Part 7 type protection to cover the default rules and trades of Multilateral Trading Facilities for all affected parties, including creditors? What other options should the Government consider?
66.	Do you agree that the AFME Protocol is a sufficient solution for the issues identified around OTC cash equity trades not covered by default rules or default terms of business? How could the Protocol be improved?
67.	Do you believe the AFME Protocol, or an equivalent, should be placed on a regulatory footing? What would be the advantages and disadvantages of this step?
68.	Do you have views on the valuation mechanism which should be used in a market Protocol on OTC cash equity trades? In particular, should it be gross or net, and what would be the advantages and disadvantages of each methodology?
69.	Are there any other asset classes that the Government should consider for which lack of default terms has proved problematic in the event of the insolvency of a counterparty, or may in the future? If so, please specify.

Question number	Question
70.	What would be the advantages and disadvantages of extending the protections provided by Part 7 of the Companies Act 1989 to cover underlying client trades for clients, counterparties and creditors? Can you give any indication of the possible costs and benefits of intervention in this area, and its distributional impact?
71.	Are there any other solutions the Government should be considering to promote margin portability?
72.	Initial discussions with stakeholders indicate that there would be negligible costs for market infrastructure providers and market participants in mandating the offer by CCPs of segregated accounts, as this is already offered as standard by CCPs in the UK. The Government would welcome comments on this assumption. Initial discussions also indicate that mandating investment firms to offer a choice of account at clearing would have an average one-off cost, per investment firm, in the region of US $5-10 million for an investment firm to develop this capacity, and an approximate annual maintenance cost of $5 million. The Government would welcome feedback to improve this estimate and, in particular, how it might impact on firms of different sizes. Do you agree with these costs? If not, please provide an estimate of the costs that are likely to occur, stating your assumptions.
73.	Do you agree there would be value in the introduction of an explicit requirement that CCPs offer facilities for members to segregate their business?
74.	To what extent is it necessary to require clearing member investment firms to offer their clients a choice of account types for the purposes of clearing? What would be the advantages and disadvantages?
75.	Are there any other issues which you believe need to be resolved at clearing level, regarding the insolvency of an investment firm? If so, please provide details.
76.	Does EUI's proposed approach to settlement provide greater predictability and are there ways it could be improved?
77.	Have the key consequences of EUI's proposal to increase certainty of settlement been identified correctly and do the benefits for the market as a whole of the proposed revised approach outweigh these consequences?
78.	Do you believe that Government action is required to address contractual terms issues?
79.	If you do believe regulation or legislation to address terms of business between investment firms and investment manager is required, which issues do you think are the highest priority? Which types of measures would best address them?
Chapter 7 – Managing complex creditor positions	
80.	Do you agree that regulatory or legislative action is not required if a suitable market solution is reached with respect to the issue of terminating derivatives contracts as set out above? Do you have views on what type of regulatory or legislative action will be most appropriate should there be no market solution to this issue?
81.	Do you agree with the proposal for a resource centre to aid administrators of investment firms?
82.	Do you have views on the difficulties that repo market transactions could pose for the insolvency of an investment firm, affecting value recovered for creditors? If this is a concern, what kind of policy action could the Government consider to address it?
83.	In relation to the areas listed here, are there any concerns that would substantially change the distribution of the outcome? Are there any other areas not covered here that may create negative externalities for unsecured creditors?

Question number	Question
84.	Are there any specific factors with respect to the loss of market confidence and complexity of business that affect unsecured creditors, which are not addressed here and which the Government should consider?
	Annex C – Consultation Stage Impact Assessment
85.	Do you have any suggestions which could help improve the Government's proposed quantification strategy? If so, please specify what these are.
86.	Are you able to provide an estimate of the financial impact of any delays or issues with LBIE's resolution process on your firm, as a counterparty, client and/ or creditor? If so, please provide an estimate for losses in the areas below, and what caused them. Please give the Government an idea of your firm's size. • For counterparties, please provide any information about the cost to your firm of uncertainty about what would happen to trades at trading, clearing and settlement, inability to hedge exposures, and the need to double-margin. • For clients, please provide any information on resources allocated to sorting out an investment bank failure, and any cost from inability to use capital and assets tied up in the investment firm. • For unsecured creditors, please provide any information about losses caused by destruction of the intrinsic value of the firm's estate as a result of events occurring after the administration.
87.	Are you able to provide any information which might help the Government quantify the ongoing or broader 'ripple' impacts of issues with the resolution process of a failing investment firm as described above? If so, please provide an estimate.
88.	Are you able to provide any information that would help the Government to assess the loss of confidence caused by any problems with the resolution process itself, as described above? If so, could you please provide an estimate of costs associated with the loss of confidence?
89.	By what percentage do you believe the proposals in this document might reduce any issues associated with the resolution process for an investment firm? Do you agree that, as a minimum, the overall package of measures proposed has potential to reduce any difficulties by 50%?

C Consultation stage impact assessment

The Government is committed to cost-benefit analysis of its proposals to improve the resolution of a failing investment firm. This analysis is crucial to ensure policies achieve their goals in a proportionate manner, without imposing undue costs.

The Government's approach to cost-benefit analysis in this document is to probe costs and benefits through asking specific consultation questions. Questions on costs are integrated alongside policy proposals in the main text of this consultation document, and questions on benefits can be found below. The responses the Government receives will help shape the full impact assessment, which will be included with the next consultation document in 2010.

In this section of the document, we set out the Government's proposed approach to cost-benefit analysis, and summarise initial predicted costs and benefits.

Approach to cost-benefit analysis

Approach to costs

Our strategy for this document is to integrate initial estimates of costs, derived from preliminary consultation with stakeholders, alongside policy proposals in the document. At each point where measures are likely to impose a cost, the text suggests an initial estimate, and invites feedback. These numbers will form the basis of an impact assessment in the next document.

These figures are initial estimates, founded on the average cost to an affected firm. Further work will be necessary to establish the range of outcomes likely for different sizes, and types, of firm, and to scale this information up for the economy as a whole.

Approach to benefits

Calculating benefits is more challenging than calculating costs. Whereas costs are typically concentrated on particular groups, benefits are likely to be diffuse. It may be challenging to separate the costs of the insolvency event itself, from the costs of problems with resolution. However, it is important to develop a picture which is as accurate as possible, in order to compare this against projected costs.

The Government's proposed approach to calculating benefits is as follows:

- Assess the benefits of improved resolution arrangements for those directly impacted by an investment firm failure, i.e. the costs directly impacting on clients, counterparties and creditors, and the proportion that could be saved if improved resolution was in place.
- Assess the broader, ripple effects of the insolvency situation on the wider financial system, including: knock-on consequences of loss of liquidity caused by assets and money being tied up, inability to resolve counterparty positions, costs potentially transmitted to the prices charged to clients, insolvency of clients, counterparties or creditors caused by issues with investment firm resolution.

- Quantify the benefits of a better resolution process on confidence of firms to do business in the UK. This analysis will involve assessing to what extent hedge funds and prime brokerage assets under management may have left the UK since, for example, the LBIE insolvency, and what proportion of this is attributable to the insolvency.

Some costs and benefits will occur only when experiencing an investment firm failure ('contingent" benefits/ costs), while others will occur even without a bank failure ('non contingent" benefits/ costs). The net benefits (i.e. total benefits less costs) of the proposals over the given time period will vary, depending on whether or not an investment firm failure occurs.

To address this, the Government intends to provide a range of expected value of net benefits. The range of expected value of the net benefits will be estimated from a sensitivity and risk analysis mainly looking at the net benefits according to the level of likelihood of failures; the threshold of probability within a given timescale for which the net benefits will be zero or positive; and historic data relating to banking crises.

It should be stressed that the impact assessment will not make any comment on the occurrence or not of a likely investment firm failure. Rather, it provides a framework for weighing the relevant evidence on the positive and negative impacts of proposals.

The Government would welcome comments as to how this quantification strategy can be improved.

Question 85

Do you have any suggestions which could help improve the Government's proposed quantification strategy? If so, please specify what these are.

Initial summary of expected costs and benefits

Summary of benefits

The Government expects measures in this area to have the following direct benefits to counterparties, clients and creditors of a failing investment firm:

- For counterparties, greater certainty about what will happen to their trades at trading, clearing and settlement, reducing losses which may stem from inability to hedge their exposures. Also, a reduction in the need to double-margin from greater ability to transfer margin, with positions, to a new broker.

- For clients, swifter identification and return of money and assets owed to them by an insolvent investment firm, reducing resources allocated to identifying and regaining money and assets, including legal fees, and the opportunity cost of being unable to use capital and assets tied up in an insolvent investment firm.

- For unsecured creditors, reduction in the destruction of the intrinsic value of the firm's estate as a result of events occurring after the administration.

- Benefits to the broader economy and financial stability. By reducing the impact on counterparties, clients and creditors, there will be a consequent reduction in the knock-on impacts on the broader economy and financial stability e.g. redundancy and insolvency of client, creditor or counterparty firms.

- Ongoing, non-contingent benefits from increased confidence in the UK regime, including willingness of clients to use UK-based prime brokerage services, and willingness of counterparties to trade using the UK trading, clearing and settlement infrastructure.

Quantifying these benefits is challenging. The Government intends to provide an estimate of these benefits in the Impact Assessment next document. In the meantime, it is seeking stakeholder input to assess the likely benefits at a firm-specific level.

In all cases, the Government is looking for information on difficulties with the resolution process, and not with the consequences of the failure itself.

Question 86

Are you able to provide an estimate of the financial impact of any delays or issues with LBIE's resolution process on your firm, as a counterparty, client and/ or creditor? If so, please provide an estimate for losses in the areas below, and what caused them. Please give the Government an idea of your firm's size.

- For counterparties, please provide any information about the cost to your firm of uncertainty about what would happen to trades at trading, clearing and settlement, inability to hedge exposures, and the need to double-margin.
- For clients, please provide any information on resources allocated to sorting out an investment bank failure, and any cost from inability to use capital and assets tied up in the investment firm.
- For unsecured creditors, please provide any information about losses caused by destruction of the intrinsic value of the firm's estate as a result of events occurring after the administration.

Question 87

Are you able to provide any information which might help the Government quantify the ongoing or broader 'ripple' impacts of issues with the resolution process of a failing investment firm as described above? If so, please provide an estimate.

Question 88

Are you able to provide any information that would help the Government to assess the loss of confidence caused by any problems with the resolution process itself, as described above? If so, could you please provide an estimate of costs associated with the loss of confidence?

Question 89

By what percentage do you believe the proposals in this document might reduce any issues associated with the resolution process for an investment firm? Do you agree that, as a minimum, the overall package of measures proposed has potential to reduce any difficulties by 50%?

Summary of costs

The Government has been working with stakeholders to develop a high-level understanding of the average cost of proposed measures on firms operating in the industries under discussion.

The tables below summarises the initial cost estimates for firms and for the Authorities, and gives a reference for where in the document these figures, and their associated questions, can be found.

Table C1: Summary of costs to market participants –

- Costs are initial estimates derived in conjunction with industry, based on the average cost to an affected firm
- Costs are given in $US or £ sterling according to which is the most commonly used unit of measurement for the activity in question

Policy proposals	Estimated cost £Sterling or $US
1. Special administration objectives (SAOs)	N/A – no market action required
2. Changes around administrator liability	N/A – no market action required
3. Modification to insolvency legislation around directors' liability	N/A – no market action required
4. Explore obstacles to the provision of intra day funding	N/A – no market action required
5. Develop effective communication plans	N/A – no market action required
6. Business resolution officers	Discussions with stakeholders indicate that the additional responsibilities of a Board-level officer as a BRO would require 10-20 per cent of their time on an annual basis or £100,000 to £200,000 per annum.

Policy proposals	Estimated cost £Sterling or $US
7. Investment firm resolution plans	Discussions with stakeholders indicate that for the prime brokerage business, initial costs of setting up investment firm resolution plans would be about £1-£3 million, with a team of about ten people. The prime brokerage business is likely to incur an additional £0.5-£1 million per year for continually updating the investment firm resolution plans, with a team of three people. Stakeholders have suggested that costs for the entire investment banking business, including prime brokerage, would be approximately five times the costs for the prime brokerage business mentioned above; £5-15 million one-off costs, and £2.5-£5 million annual costs.
8. Business information packs	Discussions with stakeholders indicate that costs would be similar to those for investment firm resolution plans. For the prime brokerage business, initial costs would be about £1-£3 million and annual costs would be £0.5-£1 million per year. For the entire investment banking business, costs would consist of approximately £5-15 million one-off costs, and £2.5-£5 million annual costs.
9. Continuity of key services	Costs associated with this policy would depend on exact conditions of contracts and the number of key staff or nature of services required. The policy proposed here is likely to lead to additional costs for negotiating contracts specific to individual legal entities. Stakeholders consider the legal costs of re-negotiating contracts for both staff and suppliers to be in the region of £40,000 to £200,000, which are unlikely to be as substantial as costs of on-shoring systems and services.
10. Operational reserve	Discussions with stakeholders indicate that an operational reserve of $25-50 million would be required for the investment firm's prime brokerage business. Annual opportunity cost of such funds is likely to be about 30 to 40 basis points. Additionally, provision of funds within the reserve for incentivising key staff to continue post insolvency is likely to amount to approximately $10-30 million for key staff only of the entire investment banking business of a firm. Annual opportunity cost of such funds is likely to be about 30 to 40 basis points.
11. Increase clarity over the allocation of shortfalls in an omnibus account	N/A
12. Mandate product warnings in contractual agreements	Discussions with stakeholders indicate that there would be a one off cost of £9,000 per warning per firm in legal costs (calculated at 30 legal hours at £300 an hour) for firms to integrate FSA risk warnings into their standard contacts.

Policy proposals	Estimated cost £Sterling or $US
13. Encourage clarity in contractual agreements	N/A
14. Increase reporting and record-keeping requirements	Discussions with stakeholders indicate that there would be a one-off cost of $1.5m for each firm to build a reporting system, assuming that they did not have such a system already in place. If they did have a reporting system in place, it would cost an estimated $0.5m to expand its capabilities. Ongoing maintenance of a reporting system could cost up to $2m.
15. Increase audited disclosures by firms around client money and assets	It is estimated that increased auditing requirements could cost £30,000 for each firm, based on 200 additional auditing hours at £150 per hour.
16. Make client asset officers directly accountable	Negligible – would just require an individual within an investment firm to become responsible for directing client assets.
17. Support the establishment of bankruptcy-remote SPVs for client assets	N/A – no market action required
18. Substantial limitations on the transfer of client money	Discussions with stakeholders indicate costs to firms of £15,000 in legal costs (50 legal hours at £300 per hour) if investment firms were prohibited from transferring client monies to jurisdictions where there are interoperability issues with CASS. Requiring all investment firms to limit the transfer of client money to affiliates would cost around £15,000 (50 legal hours at £300 per hour) in legal costs.
19. Change the regime regarding custodians' right of lien over client assets	Discussions with stakeholders indicate that there would be a one off cost to firms of £15,000 (50 legal hours at £300 per hour) in legal costs per custodian to renegotiate these agreements. Additionally custodians may charge a fee (a basis point charge calculated on activity) or they may require average turnover pledged on an account.
20. Require firms to have the ability to divide client money into different pools	Discussions with stakeholders indicate that there would be a one off cost to firms of £15,000 – £1m depending on the extent to which firms already have the capability of dividing client money into different pools. There would also be a maintenance cost to firms of around £750,000 to maintain these separate pools.
21. Establish bar dates for client claims	Discussions with stakeholder indicate that there would be negligible costs to clients if there were bar dates for client claims.
22. Establish a client assets trustee	It is expected that any additional costs of the CAT proposal would be negligible due to the assumed faster return of client money and assets by the CAT, and the resulting fall in expected administration costs.
23. Establish a client assets agency	Negligible
24. Extend protections similar to those of Part 7 of the Companies Act 1989, to MTFs.	N/A

Policy proposals	Estimated cost £Sterling or $US
25. Monitor the development of the market Protocol for OTC cash equity trades.	N/A
26. Explicit requirement that CCPs offer facilities for their members to segregate client business.	Discussions with stakeholders indicate that there would be negligible costs for market infrastructure providers and market participants in mandating the offer by Clearing Houses of segregated accounts, as this is already offered as standard by clearing houses in the UK.
27. Consider requirement that investment firms offer facilities to segregate client business.	Discussions indicate that mandating brokers to offer a choice of account at clearing would have an average one-off cost, per investment firm, in the region of $5-10m for an investment firm to develop this capacity, and an approximate annual maintenance cost of $5m.
28. Monitor the development of EUI proposal to prevent uncertainty of settlement in future.	N/A market measure
29. Monitor market action on uncertainties in contractual terms between investment firms and clients.	N/A
30. Support proposals to enable a greater degree of certainty with respect to derivatives transaction terminations	N/A – market measure
31. Set up a resource centre	N/A – no market action required

Table C2: Summary of proposals: Costs to authorities

These are preliminary estimates only, based on high-level approximations of what policy measures might entail. Detailed estimates, based on full analysis of proposals, will be included in the next document.

Policy measure	Estimated cost
1. Special administration objectives	negligible – processes exist already
2. Changes around administrator liability	negligible – processes exist already
3. Modification to insolvency legislation around directors' liability	negligible – processes exist already
4. Explore obstacles to the provision of intra day funding	Initial set-up costs of £300,000 followed by £200,000 per annum
5. Develop effective communication plans	£150,000, based on two full time staff and associated costs.
6. Business resolution officers	This table provides total costs of proposals 6 to 10 together, as dividing costs between these proposals would lead to spurious accuracy at this stage. The total cost would include policy development and initial implementation costs (including training and supervision) of £1.5 million. This is likely to be followed by ongoing costs of £500,000 per annum.
7. Investment firm resolution plans	See total costs in proposal 6 above.

Policy measure	Estimated cost
8. Business information packs	See total costs in proposal 6 above.
9. Continuity of key services	See total costs in proposal 6 above.
10.Operational reserve	See total costs in proposal 6 above.
11. Increase clarity over the allocation of shortfalls in an omnibus account	N/A
12. Mandate product warnings in contractual agreements	Initial £50K for policy development although negligible thereafter.
13. Encourage clarity in contractual agreements	Initial £50k for policy development although negligible thereafter.
14. Increase reporting and record-keeping requirements	Initial £3m and then £200k p.a. for data review and IT support.
15. Increase audited disclosures by firms around client money and assets	Negligible – processes already exist.
16. Make client asset officers directly accountable	Negligible – processes already exist.
17. Support the establishment of bankruptcy-remote SPVs for client assets	Negligible – processes already exist.
18. Substantial limitations on the transfer of client money	Initial costs of £50k for policy development, but negligible thereafter.
19. Change the regime regarding custodians' right of lien over client assets	Initial £50k for policy development, but negligible thereafter.
20. Require firms to have the ability to divide client money into different pools	Initial £50k for policy development although negligible thereafter.
21. Establish bar dates for client claims	Negligible – processes already exist.
22. Establish a client assets trustee	Negligible
23. Establish a client assets agency	It is expected that the FSA will allocate more resources to client asset risks in the future, to perform work that could be taken on by the CAA. The incremental costs of the CAA are therefore expected to reduce.
24. Extend protections similar to those of Part 7 of the Companies Act, 1989, to MTFs.	A one off £50k for policy development and £200k annual cost.
25. Monitor the development of the market Protocol for OTC cash equity trades.	N/A - market measure.
26. Explicit requirement that CCPs offer facilities for their members to segregate client business.	A one off cost of £50k for policy development, and negligible on-going annual costs
27. Consider requirement that investment firms offer facilities to segregate client business.	One off cost of £50K for policy develop and annual cost of £200K for verification and enforcement.
28. Monitor the development of EUI proposal to prevent uncertainty of settlement in future.	N/A – market measure.
29. Monitor market action on uncertainties in contractual terms between investment firms and clients.	N/A – market measure.

Policy measure	Estimated cost
30. Support proposals to enable a greater degree of certainty with respect to derivatives transaction terminations	N/A – market measure.
31. Set up a resource centre	£500K to set up resource centre. Ongoing annual maintenance of £80k.

D How to respond

This document is available on the HM Treasury website at www.hm-treasury.gov.uk. For hard copies, please use the contact details below.

The Government invites responses to the consultation questions in Annexe B. Responses are requested by March 16th 2010 during which time the Government will also engage directly with relevant stakeholders.

Please ensure that responses are sent in before the closing date. The Government cannot guarantee to consider responses that arrive after that date. Responses may be sent by email to: alex.white@hmtreasury.gov.uk

Alternatively, they can be posted to:

Investment Banking Resolution

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

When responding, please state whether you are responding as an individual or on behalf of an organisation.

Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004).

If you want the information that you provide to be treated as confidential, do mark this clearly in your response. However, please be aware that under the FOIA, there is a Statutory Code of Practice with which public Authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless and explicit request for confidentiality is made in the body of the response.

Code of practice for written consultation

This consultation process is being conducted in line with the Code of Practice (http://www.berr.gov.uk/files/file47158.pdf) which sets down the following criteria:

- When to consult. Formal consultation should take place at a stage when there is scope to influence the policy outcome.
- Duration of consultation exercises. Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
- Clarity of scope and impact. Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
- Accessibility of consultation exercises. Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
- The burden of consultation. Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
- Responsiveness of consultation exercises. Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
- Capacity to consult. Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

If you feel that this consultation does not fulfil these criteria, please contact:

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

E

Glossary of terms

Term or Abbreviation	Explanation
Banking Act 2009	The Banking Act received Royal Assent on 12 February 2009. The Act builds on the tripartite framework to enhance the ability of the Authorities (the Bank of England, the Financial Services Authority and the Treasury) to deal with crises in the banking system, to protect depositors and to maintain financial stability. The centrepiece is a new permanent Special Resolution Regime (SRR), providing the Authorities with a range of tools to deal with banks and building societies that are failing.
CASS	The FSA's *Client Assets sourcebook*, which contains the rules and guidance applying to authorised firms holding client money and assets as defined therein.
Client money	Money which an investment firm holds on behalf of a client either with itself or with a third party, and which would be subject to the FSA's CASS rules relating to the handling of client money and assets.
Client underlying trade	A client trade cleared through a CCP usually consists of two trades: one between the client and its clearing member, the other at CCP level between the clearing member and the CCP. In this document, we use the term 'client underlying trade' to refer to the trade that takes place between the client and the clearing member.
Encumbered assets	Property that is owned by one party but subject to the legal claims of another party.
Financial instruments	A contract involving a financial obligation. Examples are stocks, bonds, loans and derivatives.

Term or Abbreviation	Explanation
Financial markets	Markets for sale and purchase of stocks (shares), bonds, bills of exchange, commodities, futures and options, foreign currency, etc., which work as exchanges for capital and credit.
Financial Services Bill	A Bill to make amendments to the Financial Services and Markets Act 2000. This includes provisions relating to financial education, financial services and markets and the administration of court funds by the Director of Savings.
Investment firm	Any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis.
Margin	When parties trade through a central counterparty (CCP), the CCP calls for a quantity of cash or securities from each party known as 'margin'. If one of the parties to the trade defaults, the CCP uses the margin to cover payments due under the trade to the non-defaulter.
MiFID	The EU directive that created common regulations for investment services in each member state.
Reforming financial markets	On 8 July 2009, the Government published Reforming financial markets, setting out analysis of: the causes of the financial crisis which has led to the world economy being hit by the worst global economic downturn for the last 60 years; the actions already taken to restore financial stability; and further reforms necessary to strengthen the financial system for the future.

Term or Abbreviation	Explanation
Rehypothecation	A practice in securities trading whereby clients agree to transfer ownership of their assets and money to the investment firm. A client may agree to do this to secure its present, future, actual or contingent obligations. A client may also have their assets held in segregated custody but grant the firm a right of use over the assets. Where clients grant investment firms such rights of use, the firm takes title to those assets and is able to transfer this to third parties. Such right of use can be limited, unlimited or subject to agreement between the parties. It is often used to finance margin lending to clients, by allowing the firm to use the assets as collateral.
Unencumbered assets	Property that is free from debt, clear of any legal claims by another party or defect in its title and, therefore, can be easily sold or mortgaged.
Source: HM Treasury	

F List of participants

The Government has established an Investment Banking Advisory Panel to provide advice on the policies laid out in this document. It has consulted with a wide range of industry stakeholders including, but not limited to, the following organisations.[38]

AKIN GUMP STRAUSS HAUER & FELD LLP

ALLEN & OVERY LLP

ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

BANK OF ENGLAND

BNP PARIBAS

BRITISH BANKERS' ASSOCIATION

CHI-X EUROPE LTD

CLIFFORD CHANCE

EUROCLEAR UK & IRELAND

FINANCIAL MARKETS LAW COMMITTEE

FINANCIAL SERVICES AUTHORITY

FUTURES & OPTIONS ASSOCIATION

GOLDMAN SACHS INTERNATIONAL

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INSOLVENCY SERVICE

INVESCO PERPETUAL

INVESTMENT MANAGEMENT ASSOCIATION

J.P.MORGAN

KPMG

LINKLATERS LLP

MORGAN STANLEY INTERNATIONAL

SHEARMAN & STERLING LLP

SIMMON & SIMMONS LLP

[38] Inclusion on this list does not indicate that the individuals and organisations below take any views on the proposals in this document.

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London

SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861

E-mail: public.enquiries@hmtreasury.gov.uk

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