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By email only

Dear David

FSA Consultation Paper CP08/22: Strengthening Liquidity Standards (the Paper)

1. THE CITY OF LONDON LAW SOCIETY

The City of London Law Society ("CLLS") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response FSA CP08/22 (Strengthening liquidity standards) has been prepared by the CLLS Regulatory Committee. Members of the CLLS Regulatory Committee (the **Committee**) advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

2. RESPONSE TO THE PAPER

The Committee does not take it upon itself to comment on any policy aspects of the Paper. Rather, our concern is to ensure legal certainty in connection with the obligations which would be imposed on firms under the proposed text set out in Appendix 1 to the Paper (**draft BIPRU 12**). There are several aspects of draft BIPRU 12 which we believe require further consideration and clarification.

2.1 Cross-border banks

Our main concern about the proposed rules is their application to cross-border banking arrangements involving UK branches of foreign banks.

Compatibility of proposals with applicable law and regulation

The application of liquidity regulation to UK branches of foreign firms (including EEA firms) is a difficult area, and one where the rules need to take account of different legal and regulatory systems. While the Paper acknowledges the importance of legal entities to liquidity regulation, it is unclear from the Paper whether the proposals or the draft rules are compatible with the law and regulations governing non-UK firms. By way of example, a move to require effective decentralised treasury management could run counter to the home state regulation, or constitution, of a non-UK firm.

Location and control of assets

Draft BIPRU 12.1.1(2)(b) requires that UK branches of foreign banks do not, for the purposes of the overall liquidity adequacy rule, only include liquidity resources that are: (i) located in the UK; and (ii) under the control of the branch's senior management. These are two separate requirements and they need to be considered as such.

Location of assets

The question of location of assets may not be always readily resolved and, in our view, may not necessarily achieve the aim for which this provision appears to have been intended.

With reference to draft BIPRU 12.2.5 and 12.2.6, and to the discussions in paragraphs 2.12-2.15 of the Paper, the FSA's stated aim appears to be to ensure that UK branches of foreign firms are self sufficient and have adequate liquidity resources "under the day-to-day control of the senior management of the UK branch". It is, in our experience, common practice for both UK firms and UK branches of foreign firms to hold liquid assets with third party custodians, who may or may not be located in the UK. Further, certain assets may be dematerialised in clearing or settlement systems established in non-UK jurisdictions (for example, Euroclear in Brussels and DTCC in the USA), with the result that the location of those assets may be the relevant non-UK jurisdiction. In each of these instances, the assets in question will be or will be likely to be, as a matter of law, located outside the UK but will remain in the day-to-day control of the UK firm or UK branch. To put it another way, the presence of assets outside the UK does not, in and of itself, place those assets outside of the control of the UK branch or otherwise impair the self-sufficiency of that branch.

As currently drafted, draft BIPRU 12 purports to render such assets eligible for inclusion in the liquidity resources of UK firms but ineligible for inclusion in the liquidity resources of UK branches of foreign firms, with no apparent legal justification for this difference. It is arguable that such a provision is in breach of Article 41 of the Recast Banking Consolidation Directive (Directive 2006/48/EC) (the **BCD**), which states that measures for the supervision of liquidity "must not provide for discriminatory or restrictive treatment based on the fact that a credit institution is authorised in another Member State."

Clarification is needed from the FSA as to the intended interpretation of "located in the UK" and to the reasons behind the apparent inequity between eligible assets for UK firms and UK branches of foreign firms.

Control of assets

The question of whether assets are under the control of the senior management of the branch appears to merit further clarification. Questions arise as to whether the control should be exclusive or non-exclusive. If control is to be exclusive, this is likely to raise corporate governance questions as a matter of the law of the jurisdiction of incorporation of the relevant firm – as well as possibly casting doubt on compliance with regulatory systems and controls requirements of the firm.

2.2 Conditions to obtaining a liquidity waiver or modification

We understand that before agreeing to modify or waive the overall liquidity adequacy rule set out in draft BIPRU 12.2.1, the FSA would ordinarily expect to be satisfied that the conditions in draft BIPRU 12.8.11(1) and (2) G and draft BIPRU 12.8.19(1) and (2)G (the **Home Regulator Conditions**), and certain other conditions, have been met. The Home Regulator Conditions are that the home regulator has:

(a) a liquidity regulation regime which is equivalent to, or more onerous than, BIPRU 12; and

(b) given legal effect to, and regulates in accordance with, the "Principles for Sound Liquidity Management and Supervision" dated September 2008 (the **Liquidity Principles**) issued by the Basel Committee on Banking Supervision (the **Basel Committee**).

We do not expect that there is any argument within the industry with the principle that the FSA ought to be satisfied that UK firms or branches within cross-border financial groups are subject to adequate and appropriate liquidity monitoring regimes, and we make no comment in furtherance of any debate as to what is considered adequate and appropriate in the current economic climate. However, the interpretation and practical implementation of the Home Regulator Conditions raises a number of questions.

The Paper does not provide any guidance as to how the FSA will assess 'equivalence' in this context or how it will measure how onerous a liquidity regime is. It is also not clear whether the FSA expects each firm to address the Home Regulator Conditions on an individual basis, or whether the FSA will consider the Home Regulator Conditions as part of its dialogue with other regulators and thereby establish some form of list of jurisdictions with acceptable standards. No framework exists currently for reciprocity in liquidity regulation. The EU legislation, in recital 69 to the BCD[1], argues for some degree of harmonisation in the regulation of liquidity but it remains to be seen whether European and non-European regulators will also move to regulate financial firms' liquidity and, if they do, what form such regulation will take and the likely timeframe for implementation. In any event, we believe the FSA is the first financial regulator to produce draft rules addressing liquidity in the context of the Liquidity Principles. We also note that the FSA's proposed requirements go beyond the Liquidity Principles in a number of respects – increasing the likelihood of jurisdictions which merely implement the Liquidity Principles being non-equivalent.

The FSA has indicated, in paragraph 7.22 of the Paper, that the whole firm liquidity waiver is intended to replace the current global liquidity concession framework, pursuant to which a large number of cross-border financial groups currently measure and monitor the liquidity of their UK-based branches. For the reasons outlined above, it appears that the modification and waiver process may be of little utility, at least in the near term.

[1] "The arrangements necessary for the supervision of liquidity risks should also be harmonised."

In such circumstances, we would urge the FSA to provide further consideration and guidance to the circumstances in which it expects it might agree to modify or waive BIPRU 12, including whether there might be scope for temporary modifications and / or waivers to be granted pending further action by other regulators. It would be useful to understand whether the FSA has formed any preliminary views in relation to particular jurisdictions and in relation to the steps it would expect firms to undertake in an effort to satisfy the Home Regulator Conditions.

2.3 First-to-market regulation

In addition to the questions of liquidity waivers or modifications set out above, there is a broader concern with the FSA taking a "first to market" approach to liquidity regulation. Although it is outside the scope of the CLLS's remit, we note that by going beyond agreed international standards the FSA could affect the competitiveness of the UK as a location for financial institutions. We believe that it is critical that measures which may have such a fundamental impact on cross-border financial activities should be developed through international consensus: a unilateralist approach risks seriously affecting the competitiveness of the UK as a centre for financial services. We therefore strongly urge the FSA to ensure that no measures are introduced which materially differ from those agreed internationally without careful impact and cost-benefit analysis.

In addition, the risk of duplicative and/or inconsistent requirements should not be underestimated. Should foreign regulators take steps to regulate liquidity in the coming months or even years, it seems unlikely that they will introduce a carbon copy of the UK rules. There is a significant risk that foreign firms, or UK firms with cross-border businesses, will be required to comply with multiple, potentially inconsistent, requirements as to reporting, systems and controls and intra-group liquidity management. From a legal perspective, compliance with multiple, inconsistent regulatory regimes may not be possible; thus, placing firms in the untenable position of choosing which regulators' rules to breach.

We would therefore urge the FSA to ensure that the rules and reporting procedures dovetail, so far as possible, with those of other regulatory authorities and seek to minimise duplicative reporting requirements.

2.4 Transparency

The industry has a legitimate interest in ensuring that the FSA's rules are fairly and consistently applied, and are transparent. As it stands, the requirements of draft BIPRU 12 are subjective: the quantitative impact of the individual liquidity guidance (**ILG**) and proposed buffer of liquid assets is entirely unascertainable at this stage other than for firms on the simplified ILAS rules.

Firms and their advisors will understandably be concerned that the lack of transparency inherent in the processes proposed will result in an unlevel playing field between firms. The FSA should ensure that firms have transparency as to the process by which it determines liquidity requirements – and that the process is objective and fair.

2.5 Scope and proportionality

It is crucial that the FSA has regard to the differing business and risk profiles of the broad range of firms which will be subject to the requirements of draft BIPRU 12, particularly in the context where draft BIPRU 12 constitutes a significant shift from the FSA's current quantitative, and systems and controls, requirements for liquidity management.

We anticipate that the costs of complying with draft BIPRU 12 will be a very high, possibly prohibitive, proportion of a small firm's costs of doing business and we question the corresponding

benefit in terms of reduction or management of risk. Either the scope, or the application, of the requirements should be tailored to fit the diverse array of firms that are proposed to be covered.

2.6 Timing

The Paper suggests that draft BIPRU 12 will come into force in or around October 2009. As of the date of this letter, the anticipated papers in relation to transitional provisions and reporting requirements (the **Ancillary Papers)** have not been released. As the content of the Ancillary Papers will inform the implementation of draft BIPRU 12, we would appreciate the FSA's confirmation that draft BIPRU 12 will not be finalised or have any effect until such time as appropriate consultation on the Ancillary Papers has occurred.

We would welcome further dialogue with the FSA in connection with the Paper and, specifically, the matters raised above. We look forward to further developments in connection with draft BIPRU 12 and further guidance on the interpretation of its provisions.

Yours sincerely

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Chair CLLS Regulatory Committee

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