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HM Treasury Consultation on the Special Administration Regime for Investment Firms

Response of the City of London Law Society Financial Law Committee

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This response is submitted on behalf of the City of London Law Society ("CLLS") Financial Law Committee. Details about the CLLS, the Committee and its working party for this response appear at the end of this response.

Overall the Committee welcomes the introduction of this regime. There are, however, areas that require attention, particularly to ensure a smooth meshing with the expectations raised by the FSA's regime for client money in CASS and to address issues of legal uncertainty which would be likely to inhibit the regime achieving its intended benefits.

Our response addresses the questions raised in the Consultation:

1. Do you agree with the Government's proposal to clarify the scope of the SAR through an amending order to make it clear that "client asset" includes client money? Will amending the order as described cover all the ways in which an investment firm can hold client assets? Would adapting the provisions of the SAR to apply in respect of limited liability partnerships (LLPS) or partnerships raise any significant consequences?

Yes, we agree with the principle that client assets should include client money. The changes with regard to covering LLPs and partnerships would be relatively a second order matter, but there will be policy considerations as to whether some bodies of this sort should be subject to this regime.

The question of concern is the way that the order is amended to describe client assets.

2. Do you agree with the proposals for initiation of the SAR, as set out above and in draft regulations 4 to 8?

We are in agreement with the proposed approach.

3. Should the scope of Objective 1 be amended in either of the ways as set out in paragraph 2.23?

We consider that Objective 1 should be amended in the following ways:

To allow priority to be given to the return of segregated client assets;

To allow a series of partial returns as disputes are resolved, with an obligation to seek to return as much as is prudent on each occasion. This would be essential to prevent delay in distribution of assets which do not fully meet claims, pending the resolution of all disputes (both disputes as to which clients may claim on a pool and as to whether further assets should be included in a pool). We believe this is essential to achieve rapid distribution of the majority of segregated assets (eg where there is a shortfall in a client account holding assets of several clients in a pool) and also to enable non-segregated assets to be dealt with.

To ensure that the definition of client assets and the obligation to identify and return such assets works consistently with the approach in the FSA's CASS sourcebook as applicable from time to time.

4. Do you agree with the bar dates proposal as set out in draft regulation 11?

We believe the bar date proposals are essential to make these distributions feasible. In the context of sequential distributions, the choices are to have a single bar date at the time of the initial distribution or to have a series of bar dates, but with right to share only in distributions after a claim has been lodged. We believe that the ability to make sequential distributions is desirable and that the administrator should be allowed to retain a small proportion in reserve so as to be able to make adjustments on the final distribution to reflect the correct ultimate proportions.

It is also important to state the consequence of missing a bar date. We believe that proprietorial claims that miss a bar date should be provable as unsecured claims in the insolvency. The reference to the insolvency rules is not entirely clear.

However, if it turns out there is in fact no shortfall, claims that missed a bar date should be reinstated.

We also consider it would be more appropriate, if court approval is thought to be needed, for it to be given at the point when a bar date is set. Administrators deal with distributions to creditors without need for the distributions to be approved by the court and we do not think it is appropriate for the court to become concerned in approving the amount and timing of a distribution in the normal course. Such a court hearing would be very expensive if it were to examine the methodology and its application in detail.

5. Do you agree with the allocation of shortfalls proposal as set out in draft regulation 12?

We consider that the general principle in Regulation 12 is correct, but the detail of the Regulation requires considerable work to provide a fair and workable scheme.

First, we do not think these proposals are consistent with the netting approach to pay out indicated in paragraph 2.24 and Regulation 12 should be adapted to reflect this.

As a general principle, where a client has deposited assets which it holds on behalf of its own clients or over which it has granted rights to third parties (whether by way of charge, assignment or other transfer), the rights of the clients' clients or other third parties can be no greater than those of the client itself.

Where there are competing claims as between a primary client and persons claiming through it (or between rival derivative claimants) we suggest there should be a power for the administrator to pay the money into an account acceptable to those parties or into court and that this would discharge his duties to make a distribution, leaving those parties to settle their entitlements at their own expense.

We have suggested language in Regulation 12 that addresses the above points.

Where a shortfall arises from an inadequacy of client assets in the relevant pool, then the third party should be entitled to participate in the same unsecured claims as are available to the primary client.

We do not think that as regards security interests Regulation 12(3) expresses the second concept entirely correctly. To the extent that a security claim cannot be satisfied out of assets in an omnibus account, it is likely that the security interest in its terms will also extend to any unsecured claim which the client has against the investment bank as a result of the shortfall in assets. The language of the section indicates that the security would fall away and the language should be adjusted to make clear that all that is intended is that the claim of the security holder against the assets in the omnibus account cannot exceed what the client would recover if there were no security in place.

In addition, we believe that Regulation 12 should apply where there may be a shortfall and that it need not be certain that there will be a shortfall for the rules to be operated. This is because whether there actually is a shortfall may itself depend on the outcome of separate disputes, which might result in additional assets being credited to the omnibus account and it would be wrong for the distribution of available assets to be delayed until those disputes are resolved.

6. Do you agree with Objective 2 as set out in draft regulation 13?

We agree with this objective. However, the current definition of "market infrastructure body" in Regulation 2(1) is not sufficiently comprehensive. The investment bank will not always have a relationship to an investment exchange or securities settlement system through a market contract or a market charge but as a member or participant in the relevant body and the investment bank's duties may be set out in the "default rules" or "default arrangements" section of the body's rules. We have suggested a small amendment to the definition in Regulation 2(1) to address this.

Systems, such as CREST, do not have "default rules" under section 188 of the 1989 Act - as they do not enter into market contracts (see regulation 8 of the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001). However, such systems are likely to be "designated" under the SFRs and will have "default arrangements" within the meaning of regulation 2(1) of the SFRs - which are designed to limit systemic and other types of risk which arise in the event of a participant's default. We think it would be appropriate, and consistent with the policy objective behind regulations 10(1)(b) and 13, if the concept of "default rules" in regulation 13(5) included "default arrangements" within the meaning of regulation 2(1) of the SFRs. We have suggested amendments to Regulation 13 to address the position of systems such as CREST.

7. Do you agree with Objective 3 as set out in draft regulation 10?

Objective 3 is in effect the normal primary administration objective. We believe that the commencement of this process makes it highly unlikely that objective 3 (i) as set out in Regulation 10(1)(c)(i) can be achieved in the case of an investment bank and it would be important to acknowledge this in the objectives. We therefore think that this objective should be to rescue as much of the business of the investment bank as practicable in one or more going concerns. While this does not preclude rescuing the bank itself, it rightly places emphasis on rescue of business activity rather than a particular legal entity.

We also think that there needs to be consideration in Regulation 10 as to whether the objectives are ranked or equal. Objective 2 appears to be an on-going objective and at times objectives 1 and 3(i) could conflict. We think it should be specified that Objective 1 should be given priority, except where a business holding client assets is hived down into a company able to operate as a going concern within a short period (say 21 days) of the commencement of the administration or sold within a similar period to a third party going concern. This would give a balance between the interests of saving the business and returning assets.

8. Do you agree with giving the FSA a power of direction as set out above and in draft regulations 16 to 20?

We believe that the solution above would be more appropriate than a power of direction vested in the FSA. If a power were considered necessary, we believe that this would only be appropriate in the immediate crisis of the situation and should be limited to the sort of period mentioned above in which it would be identified whether a purchaser could be found or meanwhile parts of the business could continue as a going concern. We believe there would be greater general confidence in the operation of the insolvency process, if the power were as limited as possible.

9. Do you agree that the continuity of service provisions should be extended as set out above and in draft regulation 14?

We agree with the concept, but have concerns about aspects of Regulation 14.

These concerns centre on the supply of commercial bank services (but excluding the supply of services in respect of settlement facilities and the supply of uncommitted credit). We believe they need to be addressed to achieve legal certainty and avoid unnecessary disputes distracting attention early in the process.

There needs to be greater clarity as to what services commercial banks would be forced to provide in particular as to the definition of committed credit which, apparently would have to be supplied.

It is unclear whether it is intended that undrawn committed facilities should be available for drawing, but this is a possible inference from the language. We believe it would be better if new drawings were not covered by continuity provisions, but address below the issues that would arise if they were.

Committed credit includes the undrawn part of committed facilities, even though the terms of those facilities would undoubtedly prohibit drawing after the commencement of an administration. To

allow drawings by the administrator, it would necessary to provide for the disapplication of any relevant lending conditions.

Where facilities are revolving (either short term loans or overdraft) Regulation 14 would need to be clarified to identify whether these are to be available up to their committed (or drawn) amount even though they should be repaid and redrawn. Where repayment is inevitable (eg where the investment bank has directed payment by a third party of the amount due direct to the lender prior to the insolvency), it would need to be specified whether the amount received is available to be redrawn without conditions.

It would need to be clarified whether on demand overdraft facilities are to be treated as committed or not. We would not view these as committed in any sense.

If Regulation 14 provides for repaid funds to be readvanced and/or for committed funds to be advanced unconditionally, then consideration needs to be given as to whether their repayment should be treated as an expense of the administration which must be discharged before realisations are paid to floating charge holders or dividends are paid to unsecured creditors or before the end of the administration if that occurs without any distribution. It seems to us that this should be the case and this is not achieved by Regulation 14(4). However, it would probably be balanced to disapply the rule in Clayton's case (which would have the effect of converting the whole of an overdraft over time into money advanced during an administration), so that only any amount above the starting debit balance remaining outstanding at the conclusion of the administration (alternatively the amount above the minimum debit balance in the course of the administration) is treated as an expense of the administration.

In the event that Regulation 14 provides for repaid funds to be readvanced and/or for committed funds to be advanced unconditionally, Regulation 14(4) should be amended to clarify that interest and other proper bank charges associated with those advances fall within this section and should be paid on a current basis by the administrator (even though interest on funds advanced prior to the administration will not be paid).

Finally, it needs to be recognised that suppliers outside the jurisdiction may not be able to be forced to supply and that suppliers which are themselves insolvent will not be able to supply. It may be appropriate to relieve administrators of any obligation to spend funds seeking to obtain supplies in those circumstances. This is a point of general application, though it is likely to apply to some banking facilities of an investment bank.

10. Do you agree with the modifications to Schedule B1 administration as set out above and in draft regulation 15?

We believe that these changes are broadly correct.

11. Do you agree with the interaction of the SAR and the Bank Insolvency Procedure as set out above and in Schedule 1 to the draft regulations?

12. Do you agree with the interaction of the SAR and the Bank Administration Procedure as set out above and in Schedule 2 to the draft regulations?

With regard to questions 11 and 12 we think the approach taken is practical, even though it creates a complex set of potentially interacting powers and procedures.

13. Do you agree that the Government should ring-fence the operational reserve in legislation so that it can only be used to pay certain suppliers of key services?

Whether the operational reserve is ring-fenced prior to administration is a regulatory matter. If it is ring-fenced, then it should be available to the administrator to assist in funding the administration, so the ring-fence should fall away at that point.

The City of London Law Society, the Financial Law Committee and its working party

The City of London Law Society 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 Financial Law Committee of the CLLS consists of practitioners in leading firms of solicitors practising in the City of London and advising banks, investment banks and other financial institutions and their clients on major financial transactions and financial structures, including consideration of the insolvency risks related to such transactions and structures, as well as on aspects of financial markets operations. Its working party in relation to the consideration of a special insolvency regime for investment banks consists of:

- Dorothy Livingston – Herbert Smith LLP (Chairman)
- David Ereira – Linklaters LLP
- Geoffrey Yeowart – HoganLovells International LLP
- James Curtis – Denton Wilde Sapte LLP
- Philip Hertz - Clifford Chance LLP

With review by the following members of the Insolvency Law Committee:

- Hamish Anderson - Norton Rose LLP (Chairman)
- Jennifer Marshall - Allen & Overy LLP
- Stephen Foster – HoganLovells International LLP

Interpretation

"market infrastructure body" means a recognised clearing house, recognised investment exchange, recognised overseas clearing house or recognised overseas investment exchange in relation to which the investment bank is a counterparty in a market contract or to a market charge or is a member or participant;

Special administration objectives

10.—(1) The administrator has three special administration objectives ("the special administration objectives")—

(a) Objective 1 is to ensure the return of client assets as soon as is reasonably practicable;
(b) Objective 2 is to ensure timely engagement with market infrastructure bodies and the Authorities pursuant to regulation 13; and
(c) Objective 3 is to either—
(i) rescue the investment bank as a going concern
Alternative (i) rescue as much of the business of the bank as practicable in one or more going concerns, or
(ii) wind it up in the best interest of the creditors.

(2) The order in which the special administration objectives are listed in this regulation is not significant: subject to regulation 16, the administrator must—
(a) commence work on each objective immediately after appointment, prioritising the order of work on each objective as the administrator thinks fit, in order to achieve the best result overall for clients and creditors; and
(b) set out in the statement of proposals made under paragraph 49 of Schedule B1 (as applied by regulation 15), the order in which the administrator intends to pursue the objectives once the statement has been approved.

Alternative: (2) the special administration objectives listed in this regulation should be addressed in the following way:

(a)During the period of [ ] days following his appointment the administrator should seek to identify parts of the business of the investment bank capable of operating as going concerns and to structure the business so that these activities are placed in separate legal entitities able to operate as going concerns or transferred for value to a third party going concern in pursuance of objecting 3(i);

(b)Thereafter priority should be given to objective 1 with regard to those client assets which have not been so transferred;

(c) Objective 2 shall be treated as a continuing objective throughout the administration, but shall not override the obligation of the administrator to achieve the best overall result for clients and creditors under objectives 1 and 2; and

(d) the administrator set out in the statement of proposals made under paragraph 49 of Schedule B1 (as applied by regulation 15), the way in which he intends to pursue the objectives [once the statement has been approved]. Note: it is not clear to us that this statement would be prepared or approved before the objectives were addressed.

(3) The administrator must work to achieve each objective, in accordance with the priority afforded to the objective as provided in paragraph (2), as quickly and efficiently as is reasonably practicable.

Objective 1 – distribution of client assets

11.—(1) If the administrator thinks it necessary in order to expedite the return of client assets, the administrator may [apply to the court for authority] set a bar date for the submission of—
(a) claims to the beneficial ownership, or other form of ownership, of the client assets; or
(b) claims of persons in relation to a security interest asserted over, or other entitlement to,
those assets.
Note: we do not consider that any application to the court by the administrator should be necessary, but if there were to be mandatory court involvement this would be the best point in the process.

(2) Claims under paragraph (1) include claims that are contingent or disputed.
(3) In setting a bar date, the administrator must allow a reasonable time after notice of the special administration has been published (in accordance with insolvency rules) for persons to be able to calculate and submit their claims.
(4) Where the administrator sets a bar date—
(a) the administrator shall make a distribution of client assets in accordance with the procedure set down by insolvency rules; Note: we assume that these will allow the holding of reserves in the case of dispute and payment to an agreed account or into court in a case where there is a dispute about entitlement. If not this should be dealt with in this Regulation.
(b) no distribution of client assets may be made after the bar date without the approval of the court. Note: we believe this requirement is unnecessary and this provision should be deleted. If it remains, the language should be clarified to make it clear that it applies to claims lodged at the bar date, not to the timing of the distribution.
(b) that distribution may be partial where the identified client assets are less than those claimed;
(c) further distributions may be made:. and
(d) any claims which cannot be fully satisfied by the return of client assets shall give rise to an unsecured claim in the insolvency of the investment bank to be valued as at the date of the commencement of the special administration. Note: As the bar date rules will affect claims for the return of client assets which fall outside Regulation 12 (eg because the assets are in a single designated account but some of them are missing), it is necessary to deal with the substitute claims if there are insufficient funds – these amendments leave some overlap which could be avoided with reorganisation of Regulations 11 and 12 so that common issues are dealt with only once.
(5) Where the administrator has made a distribution after setting a bar date, if the administrator then receives a late claim of a type described in paragraph (1) in respect of assets that have been distributed—
(a) there shall be no disruption to the distribution that has already taken place;
(b) the late-claiming claimant shall not be able to take any action to pursue those assets against the person to whom the assets have been returned or against any future recipient of those assets,
(c) the late-claiming claimant shall be entitled to share in distributions made after its claim has been made, but only to the same extent as if his claim had been made in a timely manner;
(d) the late-claiming claimant shall have an unsecured claim in the insolvency of the investment bank to be valued at the date of the commencement of the special administration.
Note: we believe that it might be helpful here to set out the rights of late claimants as they should not be deprived of their property rights with no substitution.
(6) The restrictions in paragraph (5) shall not apply where—
(a) the distribution was made by the administrator in bad faith in which the person to whom the assets were returned was complicit; or
(b) the person to whom the assets were returned is later found to have made a false claim to those assets.
(7) In this regulation, "bar date" means a date by which claims as described in paragraph (1) must be submitted.
(8) This regulation does not apply to client assets which should have been held by the investment bank in accordance with rules made under section 139 of FSMA (clients' money)).

Objective 1- shortfall in client assets held in omnibus account

12.—(1) This regulation applies if—
(a) the administrator concludes that there is a shortfall in the amount available for distribution of securities of a particular description held by the investment bank as client assets in a client omnibus account [or in an amount of money available for distribution in a client moneys account] which cannot be remedied following the resolution of on-going disputes; and
(b) the assets in question are not ones which should have been held by the investment bank in accordance with rules made under section 139 of FSMA (clients' money).
(2) The administrator, in making distributions, shall ensure (subject to the treatment of late claims as described in regulation 11) that the shortfall in relation to securities has been borne pro rata by all clients for whom the investment bank holds securities of that particular description in that same account in proportion to their beneficial interest in those securities.
(3) Persons (including the investment bank) with a claim on the assets of a particular client shall be entitled to participate in distributions and shortfall claims in respect of the relevant assets in accordance with their entitlement as against that client (subject to the treatment of late claims as described in regulation 11), but at no time shall be entitled to claim in aggregate in excess of the distribution which the client would have been entitled to if there had been no claim by any such person. In particular, where a client's beneficial interest in securities held in the account is subject to a security interest of a third party or the investment bank, any reduction of the client's beneficial interest as a result of the application of paragraph (2) shall limit correspondingly the right of the security holder in respect of the distribution, but shall not affect the rights of the security holder in respect of the client's shortfall claim as described in paragraph (4). [Where there is a dispute as between two or more such persons and/or one or more such persons and the client as to their respective share of a distribution, the administrator may make the distribution as agreed by all or them [or lodge the assets in court] so as to discharge his obligations in relation to that distribution as regards all such persons and the client, leaving the dispute to be resolved between them]; Note: this may be more appropriate as an insolvency rule.
(4) The shortfall borne by a client under paragraph (2) [or in relation to a client money account] is that client's shortfall claim against the investment bank ("shortfall claim") which shall rank as an unsecured claim.
(5) The value of a client's shortfall claim in relation to securities shall be based on the market price for those securities to which the shortfall claim relates on the date the investment bank entered special administration or, if that is not a business day, on the last business day prior to the investment bank entering administration.
(6) In this regulation—
"business day" has the meaning set out in section 251 of the Insolvency Act;
"client omnibus account" means an account held by another institution in the name of the investment bank, made up of multiple accounts of clients of the investment bank;
"market price" means—
(a) the middle price of the security on the day in question published by the Financial Times or an equivalent pricing source; or, if this is not possible to ascertain,
(b) a fair market value for the security as determined by the administrator based on—
(i) historic trading prices for comparable securities for the day in question as published by the Financial Times or an equivalent pricing source,
(ii) market data in respect of the relevant market on which the security is traded, or
(iii) the result of the operation of any models or pricing methodologies performed by the investment bank or a third party; and
"securities of a particular description" means securities issued by the same issuer which are of the same class of shares or stock; or in the case of securities other than shares or stock, which are of the same currency and denomination and treated as forming part of the same issue.

Objective 2 – engaging with market infrastructure bodies and the Authorities

13.—(1) The administrator shall work with—

(a) a market infrastructure body to—
(i) facilitate the operation of that body's default rules or default arrangements,
(ii) resolve issues arising from the operation of those default rules, and
(iii) facilitate the settlement or prompt cancellation of non-settled market contracts; and
(b) the Authorities to facilitate any actions the Authorities propose to take to minimise the disruption of businesses and the markets as a consequence of a special administration order being made in respect of the investment bank.
(2) In paragraph (1), "work with" means—
(a) comply, as soon as reasonably practicable, with a written request from such a body or from the Authorities for the provision of information or the production of documents (in hard copy or in electronic format) relating to the investment bank;
(b) allow that body or the Authorities, on reasonable request, access to the facilities, staff and premises of the investment bank for the purposes set out in paragraph (1),
but no action need to be taken in accordance with this paragraph to the extent that, in the opinion of the administrator, such action would lead to a material reduction in the value of the property of the investment bank.
(3) Where a market infrastructure body has made a request of the type referred to in paragraph (2), that body shall provide the administrator with such information as the administrator may reasonably require in pursuit of Objective 2.
(4) Under this regulation a person shall not be required to provide any information—
(a) which they would be entitled to refuse to provide on grounds of legal professional privilege in proceedings in the High Court or on grounds of confidentiality between client and professional legal advisor in the Court of Session; or
(b) if such provision by the body holding it would be prohibited by or under any enactment.
(5) In this regulation—
"default rules" has the meaning set out in section 188 of the Companies Act 1989(**a**);
"default arrangements" has the meaning set out in regulation 2(1) of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999; and
"enactment" includes—
(a) an enactment comprised in or in an instrument made under an Act of the Scottish Parliament;
(b) Acts and Measures of the National Assembly for Wales and subordinate legislation;
(c) Northern Ireland legislation,
and any regulation, directive or decision of the European Union.

Continuity of supply

14.—(1) This regulation applies where, before the commencement of special administration, the investment bank had entered into arrangements with a supplier for the provision of a supply to the investment bank.
(2) After the commencement of special administration, the supplier—
(a) shall not terminate a supply unless—
(i) any charges in respect of the supply, being charges for a supply given after the commencement of special administration remain unpaid for more than 28 days,
(ii) the administrator consents to the termination, or
(iii) the supplier has the permission of the court, which may be given if the supplier can show that the continued provision of the supply shall cause the supplier to suffer hardship; and
(b) shall not make it a condition of a supply, or do anything which has the effect of making it a condition of the giving of a supply, that any outstanding charges in respect of the supply, being charges for a supply given before the commencement of special administration, are paid.
(3) Where, before the commencement of special administration, a contractual right to terminate a supply has arisen but has not been exercised, then, for the purposes of this regulation, the

commencement of special administration shall cause that right to lapse and the supply shall only be terminated if a ground in paragraph (2)(a) applies.
(4) Any expenses incurred by the investment bank by the provision of a supply after the commencement of special administration in accordance with this regulation are to be treated as necessary disbursements in the course of the administration.
(5) In this regulation—
"commencement of special administration" means the making of the special administration order;
"supplier" means the person controlling the provision of a supply to the investment bank under a licence, sub-licence or other arrangement, and includes a company that is a group undertaking (within the meaning of section 1161(5) of the Companies Act 2006) in respect of the investment bank; and
"supply" means a supply of—
(a) computer software used by the investment bank in connection with—
(i) the reception, and transmission of orders in relation to securities, or
(ii) the trading of securities;
(b) financial data;
(c) broadband and electronic mail;
(d) data processing;
(e) commercial bank services (but excluding the supply of services in respect of settlement facilities and the supply of uncommitted credit).

Note: add additional provision to address issues on meaning of commercial bank services raised in CLLS response to question 9 and consider adding provision to address administrator's duties in relation to suppliers which are outside the jurisdiction or themselves insolvent.