The City of London Law Society

4 College Hill
London EC4R 2RB
Tel: 020 7329 2173
Fax: 020 7329 2190
www.citysolicitors.org.uk

Response of Financial Law Committee of the City of London Law Society on HM Treasury Paper – Establishing resolution arrangements for investment banks (December 2009)

INTRODUCTION AND EXECUTIVE SUMMARY

1. 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.

2. The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the Consultation Paper has been prepared by the CLLS Financial Law Committee and members of its working party are listed at the end of this response. We should be happy to discuss any issues if this would be helpful.

3. We are grateful for the opportunity to respond to the Consultation Paper and for the extra time afforded for this response. We have had the opportunity to read the response of the CLLS Insolvency Law Committee covering the matters raised in Chapters 2, 5 and 8 of the Consultation Paper, and the response of the Regulatory Law Committee covering in particular the matters raised in Chapter 3 and the regulatory issues in Chapter 5 of the Consultation Paper. Our comments are therefore primarily directed to the other sections of the Consultation Paper.

4. There are in all three submissions from CLLS Committees expressions of concern about an over-heavy reaction to the recent crisis and the failure of Lehman, which risks imposing very heavy burdens on market participants. There are a large number of other complex regulatory measures in the pipeline. We urge that a "proportionality" review is carried out before introducing measures, particularly those of a regulatory nature, to ensure that they do not impose undue or unnecessary burdens or cause confusion and that they do not un-necessarily affect competitiveness of firms in the market place or curtail access to the market.

5. Importantly, we consider that many of the issues addressed are not unique to investment banks. The issues relevant to the Lehmann insolvency are in many cases a result of the factual situation and only to a limited extent capable of improvement through a legislative means. Of these a special insolvency process appears less important than addressing the confusion that the courts have found in the FSA rules and in ensuring that record keeping requirements are appropriate.

6. One of the key benefits of the English legal system, which we believe is shared by its general insolvency laws, is the flexibility of those systems to deal with difficult and changing situations. We recommend therefore that care is taken not to disturb that flexibility.

7. We note that the CLLS Insolvency Law Committee considers that a strong case needs to be made before any new insolvency procedure or modified insolvency procedure is introduced. There are now over 20 "special" insolvency procedures in the UK. For the reasons stated by that Committee we very much support a "light touch" approach to any modifications to the existing administration regime for an insolvent investment firm. We consider, however, that the proposed special objectives would provide clarity and transparency both for the administrator and the counterparties as a variation of the standard objectives in an administration and would support their introduction in the case of administration of an investment bank (or indeed more generally for businesses holding third party assets). This might be better done by amendment to the Insolvency Act than by creating a special regime. As regards the proposals for a bar date for client asset and client money claims, we are strongly of the view that these would be a useful

modification to the insolvency legislation, but applicable in all cases where third party assets are held by an insolvent business, not just investment banks, and should operate to bar proprietary claims not only against the company and its administrator/liquidator, but also against any third party to whom assets are distributed.

8. We also agree with the views of the Insolvency Law Committee that, rather than lowering the standard of care for an administrator's duties (or attempting to come up with an alternative formulation for the standard of care), an administrator will be sufficiently protected if his duties are linked to the pursuit of the special objectives.

9. We, like the Insolvency Law Committee and the Regulatory Law Committee, are very concerned about the proposals in Chapter 5 of the Consultation Paper and, in particular, the proposals for the appointment of the Client Asset Trustee (**CAT**). We consider that these proposals are likely to add to the cost and complexity of the administration without giving rise to any real benefit. To have separate officeholders appointed in respect of the client assets and the general estate would inevitably lead to duplication and potentially litigation regarding the respective roles. We strongly urge the abandonment of these proposals.

10. On the cross-border side, we believe that there is no easy answer to the cross-border issues and ultimately we suspect that the UK Government can only legislate for UK firms while monitoring closely the international developments referred to in Chapter 8 to ensure that the UK proposals are not inconsistent with these developments, as well as participate in international discussions to seek to achieve maximum harmonisation, whether at EU level or through other international treaties.

CHAPTER 1

The aims discussed in the Consultation Paper are worthy. We would make only 3 points:

- HMG should guard against the temptation to have an over-elaborate response, which would impose unnecessary burdens on investment businesses and potentially damage the reputation of London as a place to do business;

- A number of the matters dealt with in this paper are matters where the EU and G20 initiatives may also apply. It is particularly important to ensure that UK legislation meshes well with EU legislation: a good example is the proposed definition of "investment bank" (on which our views are sought in **Question 1**), which is unexceptional, but, if the EU were to adopt a different approach to that in Conditions 1 and 2, then the UK approach should be aligned rather than a different definition maintained. It is therefore important that HMG engages fully in the EU legislative process and that legislation allows for amendment to achieve alignment. This assumes that the EU approach leaves the relevant areas of legislation with Member States and greater adjustment and review would be needed if measures such as living wills were regulated by a European body;
- Issues arising in the collapse of Lehman were inevitably complex, given the size and complexity of the failed business. We discuss this in detail in response to Chapter 4. It is inevitable that in such large insolvencies, resolution cannot be achieved overnight and it is important to disentangle those issues which can be addressed from those which cannot. It should also be noted that issues related to third party assets can arise in any business that holds such assets, not only investment banks. There is therefore a case for recognising this through changes to general insolvency law rather than mechanisms limited to "investment banks" as defined.

CHAPTER 2

We are in broad agreement with the views of the Insolvency Law Committee's response to this Chapter and would refer you to that response.

CHAPTER 3

We endorse the views of the Regulatory Law Committee in response to this Chapter.

We will not therefore comment on these, save to say that there needs to be a proper balance of resources between banks updating substantial plans for a relatively rare event and the conduct of day to day business, so that it would be more efficient if methodologies of record keeping that are relevant to day to day business can be utilised to provide the underlying data for a "living will", since this would be less costly and provide better incentives for investment firms to continue to do business in London than complex and expensive separate systems. As we remark in our comments on Chapter 4, we consider that it is inevitable that a business in steep financial decline is likely to let aspects of its affairs slide and the more separate the processes required, the more likely that they will be neglected.

CHAPTER 4

1 General comments

HM Treasury states at paragraph 4.2 of the Consultation Paper that the key issue 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.

By this we assume that HM Treasury recognises that there is a need for a balance between the legal and practical protections that can be given to clients' assets and monies against a firm's insolvency, and the cost and burden that those protections inevitably bring. There is little advantage in designing and implementing a system of protections if those protections are too expensive in practice and damage the competitive position of the UK.

It is also crucial to bear in mind that many of the difficulties arising in relation to the return of client assets and money in the Lehman insolvency were the product of practical issues, as HM Treasury describes at paragraph 4.6 of the Consultation Paper. While many such problems can be resolved through changes in regulation and changes to how investment banks are 'resolved', there is no quick and ready solution to guaranteeing the speedy return of all of a client's assets and money in the event of insolvency. In the imperfect and highly complex world in which investment banks operate, it is as much the responsibility of clients to recognise and manage that risk, as it is the responsibility of the investment banks and regulators to try to ensure that material risks do not arise. Again, that is another balance that we believe the Government needs to be careful to strike.

Finally, we note that the Government believes that the underlying existing protections for client money and assets are generally fit for purpose (see paragraph 4.23 of the Consultation Paper). At least with respect to the FSA's client money rules (i.e., Chapter 7 of FSA's Client Assets sourcebook), we would question this. In the Lehman court case, the courts found that what looked like a "relatively straightforward and intelligible code" for the holding and return of client money was in fact "patently inconsistent and flawed in certain significant respects" with "patent errors" in both rules and guidance. Indeed, the courts decided that aspects of the rules multiplied and aggravated the client money problems faced in Lehman.

So, while we agree that the underlying conceptual structure – i.e., the client money trust – is sound, FSA's rules implementing that trust, especially on a firm's default, cannot be described as 'fit for purpose'. One of the most urgent tasks, therefore, in the reform of client money protection is a review of the regulatory regime itself to correct the deficiencies that the courts have identified.

2 Specific responses - Chapter 4 – Reconciling and returning client property

A. 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?

Yes, we agree that the Government should look to provide clarity over the treatment of shortfalls in client asset omnibus accounts, and as to the time as at which client's entitlements should be calculated.

It goes without saying that this topic requires careful consideration to ensure that there is clarity as to what entitlements are protected. In particular:

– is protection to be limited to client's beneficial ownership interests (accepting that these may not always be in the underlying securities, but in the firm's contractual and other legal rights against relevant securities depositaries)?

– should it extend to clients whose securities should have been segregated in the account, but were not?

– what happens should securities be taken out of or added to the omnibus account when there is a shortfall on the account (e.g. where a client sells his stock and stock is delivered out of the account), whether before or after the point of calculation of entitlement?

– should the level of protection depend upon the cause of the shortfall? (E.g. if the shortfall can be attributed to a partially-failed purchase affecting a particular client, should the shortfall be borne by that client or shared on a pro-rata basis?)

– General pools of assets for sharing of losses can cause great harm and should be avoided. Great care needs to be taken to avoid creating unwanted pools. In the Lehman Claims Resolution Agreement shortfalls are determined on a stock line by stock line basis. Entitlements and losses should follow that analysis and not any broader pooling.

Given the international nature of securities holdings and the various international initiatives in this area, we would urge the Government to look for solutions which take these into account and to participate in those international initiatives.

B. Question 36

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

We would not regard this as a matter for legal intervention.

It is not obvious to us that there is any form of widespread misunderstanding in the market as to the legal effect of rehypothecation, or as to the risks (and indeed advantages) of allowing firms to operate omnibus accounts. Consequently, we consider that mandatory warnings are not strictly necessary.

Further, it is unclear what benefit would really be delivered by a mandatory warning recommending that clients negotiate limits on the firm's right of use, if the parties are to remain free (as they should be) to negotiate limits or not. And as limits are commonly negotiated and agreed to today, it would be surprising if anyone really needed a reminder. (On a smaller point, we assume that the Government does not intend that any warnings by firms would "recommend" the negotiation of limits (see paragraph 4.34), but would merely remind clients that this is something they ought to consider.)

As to whether firms should be required to offer designated accounts rather than omnibus accounts, we again believe that this can and should be left to the parties to negotiate (given the likely costs). We would also warn that designated accounts are not the panacea that some suggest, as they also carry risks that need to be appreciated and managed:

– the greater the number of separate client accounts that a firm operates, the greater the likelihood that assets/money will be credited/debited (due to operational error) to the wrong client account, and the firm's systems and controls must be sufficiently robust to manage that risk.

– given that risk, an administrator will still have to undertake a reconciliation exercise to ensure that each account has the correct assets/money credited to it and to resolve breaks (although we would hope that this would be easier if the firm's systems and controls were sufficiently robust in the first place).

– the Government should be aware that designated client money accounts are already a feature of the FSA's client money rules, but are subject to pooling on the firm's insolvency, i.e., a client is still exposed to shortfalls on other pooled accounts, even though its designated account is whole.

In addition, it ought to be remembered that firms, including UK entities for which the UK is lead regulator, may not be able to open separate designated client accounts in overseas jurisdictions – local law might require all assets to be credited to a single account, or even regard all of the assets as belonging to the firm, regardless of the account to which they are credited.

C. Question 37

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

In the wholesale markets we do not see this as an area for legal intervention. At most, FSA might set out its expectations as to 'best practice', and then monitor how firms approach and achieve greater clarity.

D. 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?

This is primarily a regulatory issue so not addressed in this response, other than to say that this is an area where a balance between what is valuable to clients, but not overly expensive or burdensome, needs to be maintained. In particular given the huge volatility which accompanies a failing firm it may be impossible to avoid a breakdown in record keeping in the last few days and tougher reporting requirements may not in reality have assisted.

E. 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?

See response to Question 36.

F. 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?

We are unable to comment on these proposals until it is clear what auditors will be asked to do, and what would then be disclosed to clients.

G. Question 42

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

We agree that there would be value in centralising CASS oversight in one approved person. However, we believe that it should be emphasized that the responsibility for a firm's compliance with its CASS obligations rests with a firm's senior management rather than just with the individual CF-29 to ensure that the firm's compliance with CASS is prioritised at the appropriate level within the firm.

H. 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?

We agree with the Government that the initiative shown by market participants in establishing insolvency remote vehicles is to be welcomed. Indeed, it may ultimately prove to be an effective way of managing some of the risks identified in this Consultation Paper. However, it is important that the Government does not take any action that may undermine the emergence of alternative measures.

I. 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?

Yes in particular firms should assess and manage the risks arising from placing client assets and money with affiliates or in jurisdictions where local laws could cause problems for the return of the assets or money on a firm's insolvency.

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?

Yes, in principle, we agree. In any event such claims should be subordinated to client claims through relevant contractual terms.

J. Question 47

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

We believe that the FSA should consult more broadly on the appropriate regime for dealing with the client money held by a firm at the time of its insolvency. The question of whether the money should be held in a single or in multiple pools should be considered as part of that broader review.

K. 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 submit a claim by a bar date? Should the Government impose a legal duty on an administrator or trustee to impose a bar date?

Yes, we agree that bar dates should be introduced. We see no reason why an administrator/trustee should not be subject to a legal duty to impose a bar date, subject perhaps to being able to seek the courts' consent to not imposing one.

This may require a broader reform. A bar date may protect the insolvent estate from breach of trust claims but it does not impact on proprietary rights so that a claimant can still make a claim against another claimant who has wrongfully received a trust asset even if they did not notify the trustee. A review of trust law is required to allow recipients to be protected. This is what the LBIE scheme of arrangement was intended to achieve but was blocked by the court. The Lehman Claims resolution Agreement does not protect claimants. In effect the required reform would be that any client who has not submitted his claim prior to the bar date should be restricted to his claims as an unsecured creditor.

L. 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?

We consider that the great strength and attraction of the UK financial market is the flexibility of its laws, and the freedom that firms and their clients have to agree the terms of their relationships, especially in the wholesale and institutional markets. We welcome the Government's recognition that it should not seek "to undermine the fundamental commerciality of such arrangements".

As noted above, we believe that there are elements to the Government's proposals that do require further consideration to ensure that this objective is achieved.

We are doubtful that any regulation is wholly ‘futureproof’ – all rules that are designed to mitigate or manage risk need to be assessed as markets change, in order to determine whether they are still performing the intended role. Further consideration also needs to be given to the application of MiFID as it impacts on affiliates and we note that this is likely to be the subject of consideration in the court of appeal on Lehman. That appeal may end up taking a long time to be finally resolved so clarity going forward would be helpful

We are unable to comment on the extent of any negative impact.

Chapter 5

We wholly endorse the views of the Insolvency Law Committee and the Regulatory Law Committee that there is no need for a separate Client Asset Trustee. We consider that the proposals in this Chapter are counterproductive and would be likely to add to the cost and complexity of the administration without giving rise to any real benefit. To have separate officeholders appointed in respect of the client assets and the general estate would inevitably lead to duplication and potentially litigation regarding the respective roles. We strongly urge the abandonment of these proposals.

A. 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 investment firm?

We believe the idea of a CAT is misconceived and would involve an unnecessary duplication of costs which would have to be born either by the owners of the assets or the creditors of the insolvent firm. Costs would only increase with the use of a separate firm, but the separate functions and duties would in any event involve huge duplication of effort. We recommend that the proposal is abandoned and that the adjustment of administrator's duties considered in Chapter 2 is all that is needed. An administrator appears in any event to be in the position of a trustee in relation to third party assets.

B. 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 methods of establishing a CAT?

As stated above we do not favour the CAT proposals at all. As the relevant assets are likely to be mixed with the assets of the failed investment bank, the proposal to vest the assets in the CAT would be productive only of litigation and uncertainty. If the CAT proposal were pursued the assets would need to remain vested in the company to the extent of its interest (which may be no more than a bare legal interest or a right of management of interests held in the name of a third party) and otherwise in the third party owner(s). Attempts to vest third party rights in a CAT could be regarded as expropriatory and an interference with property rights. This would not, however, in our view prevent the court regarding any officer with control of client assets as under the obligations of a trustee (to the same extent as the company) in relation to such assets.

C. Question 54

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

Whichever way they are funded they will undoubtedly be higher than if there were no CAT and may well be double. There could be no justification for burdening the insolvent estate, if a separate officer were dealing. There would be a case for allowing a single administrator to make a small levy on returned client assets to fund his work in sorting out and returning client assets without burdening the insolvent estate.

D. 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?

We do not agree with this proposal. The clarification of the aims of the administration, the introduction of a bar date, the regulatory proposals regarding the reporting of client assets and money and restrictions on the use of affiliates as the bankers of client money would be better ways of contributing to the speediest possible return of client money and assets.

E. 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.

We are certain that the additional costs of this proposal would be very high because of the duplicatory nature of the role, the resource intensive nature of the work and the risks of litigation. We are doubtful that it would do anything much to speed up return of assets and in some respects would slow it down. While we cannot give estimates of costs as such, we can say that the overall costs of dealing with insolvent estate and third party assets would be likely to rise by a substantial amount – probably in the range 50-100%.

The latter part of this chapter and Questions 57-61 are largely regulatory in nature and the Regulatory Law Committee has responded. Their comments raise concerns about the burden that the proposals could place on smaller businesses. We would urge that measures should be proportionate to the size and complexity of a business and not "one size fits all".

In relation to **Question 57**, we do not think that an officer of the CAA would be suited to the role of CAT unless he was also an insolvency practitioner: in any event, he would need access to the resources of the type of firm to which suitable insolvency practitioners are likely to belong. These would not be found in the CAA (as it would not be constantly dealing with insolvent investment banks) and would have to be bought in.

Question 62 asks if we have any other views on the proposals in this chapter and we would re-iterate that the CAT proposals should be abandoned.

Chapter 6

A number of the issues raised in this Chapter are addressed in the FMLC paper, Legal Proposal for normative changes to address the risk of market instability in the event of the insolvency of an investment firm, with particular reference to the problem of unsettled OTC cash equity trades of September 2009, available on the FMLC website at http://www.fmlc.org/papers/Issue140Sept09.pdf. We understand that the FMLC will be responding on the questions raised in this Chapter. Some valuable practical points are made in the AFME response, which we have seen.

We would refer you to those papers and do not propose to make detailed responses.

Chapter 7

We support the views expressed by ISDA in its response, which we have seen.

Chapter 8

As indicated above, we support the views expressed by the CLLS Insolvency Law Committee.

In particular, as the paper correctly points out, investment firms currently fall outside the scope of the Regulation on Insolvency Proceedings (EC) No 1346/2000 (the **Insolvency Regulation**) and, unless the investment firm also has a deposit-taking licence, it is also carved out from the scope of Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions (the **Winding Up Directive**). It has been our understanding that the European Commission did intend to propose either separate European legislation on similar lines to the Winding Up Directive or the extension of that Directive to cover investment firms. We believe that the UK should look for the development of such legislation and actively participate in its development.

City of London Law Society,
Financial Law Committee,
26th March 2010

Working Party Members:

Dorothy Livingston, Herbert Smith LLP (Chairman)
David Ereira, Linklaters LLP
Mark Campbell, Clifford Chance LLP
Geoffrey Yeowart, Lovells LLP
Jennifer Marshall, Allen & Overy LLP.