By email: fmisar@stablecoin@hmtreasury.gov.uk

2 August 2022

The City of London Law Society: Response to HM Treasury's consultation "Managing the failure of systemic digital settlement asset (including stablecoin) firms"

1. Introduction

1.1 In May 2022, HM Treasury published a consultation aimed at managing the risks that stem from the failure of a systemic "digital settlement asset" (**DSA**) firm, in light of the financial stability and consumer protection impacts that such an event could have (the "**May 2022 Consultation**").[1] In this response document, we adopt the definitions from the May 2022 Consultation.

1.2 The City of London Law Society (the "**CLLS**") represents approximately 17,000 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 19 specialist committees. The CLLS Insolvency Law Committee, made up of solicitors who are expert in the field, has prepared the comments below in response to the Consultation. A link to a list of the individuals and firms represented on this Committee is set out at the end of this response.

1.3 The May 2022 Consultation acknowledges the need to consider whether a bespoke legal framework would be necessary to manage the risks arising from the failure of systemic DSA firms. However, it provides that it is important to first ensure that existing legal frameworks can be applied effectively to manage the risks posed by the possible failure of systemic DSA firms for the purposes of financial stability. It is this issue that we address below, taking the questions listed at the end of Chapter 2 of the May 2022 Consultation in turn.

[1] HM Treasure Consultation: Managing the failure of systemic digital settlement asset (including stablecoin) firms, May 2022 - https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1079348/Stablecoin_FMISAR_Consultation.pdf

1.4 We have set out at the end of this response the members of the working group who were involved in drafting this response. Any member of the working group would be happy to discuss or expand on any of the comments made in this response. Alternatively please feel free to contact our chairperson, Jennifer Marshall (Allen & Overy LLP) whose details are set out below.

2. General observations on the consultation

2.1 At the outset of this response document, we wanted to list a few observations. In particular, we note that we did not think it was clear from the current consultation precisely which firms would fall within its scope. The definition at paragraph 1.8 seems to be broader than in previous consultations - for example, whilst the January 2021 consultation on the UK regulatory approach to cryptoassets and stablecoins expressly excludes algorithmic (as opposed to collateralized) stablecoins from its scope (see paragraph 3.17),[2] the May 2022 Consultation would appear to accommodate those. We have decided to address both types in this response document, however it appears to us that more clarity is needed on the scope of the May 2022 Consultation.

2.2 Whilst not directly relevant to the questions posed by the May 2022 Consultation, we would query the regime for designating a DSA firm 'systemic'. Will designation be linked to the scope of the regulatory regime that is currently under discussion? Is the intention to maintain a register of sorts, in order to allow easy and quick reference to determine those DSA firms that fall within scope?

3. Responses to specific questions

Q1 – Do you have any comments on the intention to appoint the FMI SAR as the primary regime for systemic DSA firms (as defined at 1.8) which aren't banks?

3.1 We note the FMI SAR has been selected as the anchor regime for DSA firms primarily because it provides an existing bespoke insolvency regime designed around the direction and oversight of an insolvency process by the Bank of England (rather than the FCA). In that limited sense the FMI SAR regime makes sense, although we note with caution that the FMI SAR was originally designed in its own particular context, being:

(a) that the significant majority of operators of payment and securities settlement systems do not take credit risk, and the owners and members of the payment systems typically have a strong incentive to provide the financial resources needed to support the continued provision of critical payment services. For these reasons, it is unlikely that a systemically important FMI company of this nature would become insolvent. As such, designation under the FMI SAR was

[2] HM Treasury Consultation: UK regulatory approach to cryptoassets and stablecoins, January 2021 - https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/950206/HM_Treasury_Cryptoasset_and_Stablecoin_consultation.pdf

itself expected to be rare and the circumstances where there would ever be use of the regime considered extremely remote;

(b) that any FMI administration should not continue for very long, and the FMI administrator's third objective (to ensure that it becomes unnecessary for the FMI administration order to remain in force) is expected to be achieved by either rescuing the business as a going concern; or, failing that, transferring so much of the business as is necessary to ensure that the relevant payment or settlement system continues to operate as a going concern to one or more different companies.

3.2 The design of the existing FMI SAR at outset reflected, in short, that it is unlikely to be used other than in extremely isolated scenarios, and that one way or another, the systemically important functions are likely to continue outside of administration (following rescue) or "rehoused" somewhere else. The above premises may not hold in relation to the failure of DSA firms; as such the amendments to the FMI SAR will need to cater for a potential divergence in approach (for example toward the wind down of the DSA firm's systemically important functions without it necessarily being rescued or replaced by other market participants).

3.3 We also note that it is not settled, as a matter of policy, the extent to which the ownership status of the holder is merely contractual (with the collateral backing the stablecoin being held by the DSA) or if in fact an officeholder will be dealing with custody assets sitting outside the insolvent estate, but held by the insolvent DSA as trustee. For these reason we anticipate a bespoke legal framework may be required sooner rather than later, as these questions are resolved.

Q2 – Do you have any comments on the intention to establish an additional objective for the FMI SAR focused on the return or transfer of customer funds, similar to that found in the PESAR, to apply solely to systemic DSA firms?

3.4 We have the following observations/questions on the intention to establish an additional objective that is focused on the return or transfer of customer funds:

How similar will the objective be to objective 1 of the PESAR?

3.5 Is it the intention that the additional objective will be supplemented with similar provisions to those contained in regulations 13 to 15 and 17 to 34 of the PESAR, in order to determine matters such as shortfalls in asset pools?

3.6 Will the emphasis on speed (i.e. as soon as is reasonably practicable) be included in the additional objective and if so, how will this align with the existing objective of the FMI SAR regarding continuity of service? See further below. By extension, how will any emphasis on speed be reconciled with the challenges of accuracy. As the Investment Bank Special Administration Regime has shown (as the Bloxham Review[3] considered in detail in relation to the proposed FCA "Speed Proposal") there remain

[3] Final Review of the Investment Bank Special Administration Regulations 2011 by Peter Bloxham, January 2014

considerable challenges for an insolvency officeholder in carrying out investigation, reconciliation and other work to establish accuracy in returning custody assets and a natural caution in returning such assets quickly without some mechanism to prevent subsequent challenge (for example by way of a bar date process).

The BoE's power to direct and how will the objectives work together in practice?

3.7 In order to plan for an appointment and prepare proposals, it will be crucial for an administrator in waiting to know which objective should take precedence in an administration. Noting that it is intended that the BoE will be enabled to direct administrators as to which objective should take precedence, it may be challenging for an administrator to properly plan for an appointment if there is uncertainty over which direction the BoE may take. That may be mitigated if the BoE has to declare the objective in advance and on the basis that it will not change. For example, we assume that the BoE will not be enabled to change the precedence of the objectives mid-way through the administration. It seems unlikely that an administrator would be prepared to accept an appointment where there is any uncertainty as to the strategy of the BoE.

3.8 Even with clear direction from the BoE as to which objective should take precedence in the administration, will that mean that the second objective should still be pursued in parallel, similar to the objective regime pursuant to the Building Society SAR? With such different objectives to preserve financial stability, we are concerned that the objectives are potentially irreconcilable and choosing one might be to the detriment of the other.

3.9 The objective of the FMI SAR is continuity of service and systems with a view to ensuring either the company is rescued or transferred as a going concern. In managing the business, affairs or property of a FMI company, an FMI administrator must do so for the purpose of achieving the objective '*as quickly and efficiently as is reasonably practicable'*.

3.10 Our main observation is how the regime will reconcile two potentially competing objectives, even in circumstances where the BoE has directed that one is to take precedence over the other.

3.11 The FMI SAR has an overarching objective of ensuring "continuity of service and minimizing disruption to the critical services that are vital to the efficient operation of the financial system". This objective is concerned with keeping critical or systemically important payment and securities settlement services running.

3.12 The time and effort involved in returning customer funds is seemingly difficult to reconcile with the principle objective of the FMI SAR where continuity of service and systems, with a view to ensuring a rescue or transfer as a going concern as quickly and efficiently as is reasonably practicable, is the primary objective. Further consideration as to time and effort of returning customer funds is considered below.

3.13 The consultation envisages that the BoE will be enabled to direct administrators as to which objective should take precedence in an administration, in order to ensure flexibility to the circumstances of each firm's failure so that the particular risk it presents to financial stability can be addressed.

3.14 The consultation talks about introducing specific regulations in support of the FMI SAR to ensure that it can operate effectively when applied to DSA firms, including so that the additional objective can be effectively managed by administrators.

3.15 However, if there is some priority to the order an administrator has to pursue the objectives, will he/she be criticized/in breach of duty if they decide that pursuing the additional objective would jeopardize the overriding continuity of service objective and therefore decide not to pursue? Alternatively, could the administrator be criticized for devoting too much time and resource to pursuing the additional objective? These issues should be addressed with clear regulation as to the interplay between the objectives in light of a BoE direction regarding precedence and what an administrator should have regard to when pursuing those objectives.

3.16 Might a Building Society SAR objective regime be adopted for DSAs, such that objective 1 (continuity of service) takes precedence but the administrator must work towards objective 2 (rescues as a going concern or achieving a better result for creditors as a whole than an immediate liquidation) in parallel. Pursuant to the Building Society SAR, as soon as reasonably practicable after appointment, the administrator must agree with the BoE a statement of proposals for achieving the statutory objectives. The DSA SAR may benefit from this parallel objective in conjunction with consultation with BoE on proposals. This may present the flexibility that will be demanded from each unique situation where return of customer funds may be more important than financial stability in certain cases.

Will administrators be granted additional powers by which to access customer monies?

3.17 Given the nature of the asset class, there is inherent uncertainty as to the ability and speed of an administrator being able to gain access to the customer funds in order to return or transfer them. If the stablecoin itself is to be transferred to the customer, then there will potentially be a need to grant enhanced powers to administrators of DSAs in order to compel co-operation, including, for example, the disclosure of private keys.

3.18 There is also the question of whether customer monies are held on trust, are subject to a handbook regarding customer monies (depending on the extent to which the sector is regulated in the future) or have been co-mingled with the general body of assets such that they are, in theory, available for distribution according to a statutory waterfall (noting however that the FMI SAR currently does not contain provisions regarding payment of monies to unsecured creditors). The additional objective should consider these various scenarios as to the status of customer monies and

provide appropriate guidance for an administrator to follow when pursuing the additional objective.

Will the SAR extend to algorithmic stablecoin DSA firms or just those trading in collateralized stablecoins?

3.19 If the FMI SAR is to be extended to those DSA firms which trade only in collateralized stablecoin then this may not be such an issue on the basis that the issuer of the stablecoin holds enough of the reference asset (alongside other liquid assets) to meet claims for the pegged fiat equivalent, to the value of the stablecoins held. Accessing the pegged fiat equivalent should therefore in theory be the same as recovering currency in a normal administration process. However, there will be the question of what value is returned to the customer – the value of the pegged fiat equivalent or the value of the actual coin? There is also the question of how shortfalls in the return of customer monies will be addressed (see above).

3.20 Further complications can be anticipated in relation to currency conversion noting that, in existing insolvency regimes (including the FMI SAR) the officeholder must convert all debts payable in a foreign currency into sterling at a single rate determined by the officeholder by reference to the exchange rates prevailing on the relevant date[4].

Who will pay the costs of the special administrator to pursue the additional objective?

3.21 The return or transfer of customer monies will likely be a labour-intensive exercise that will require significant professional time, costs and resources on the part of an administrator to pursue. This is especially so if the customer base is large in size, geographically and jurisdictionally diverse and the quantum of monies to return is significant.

Q3 – Do you have any comments on the intention to provide the Bank of England with the power to direct administrators, and to introduce further regulations in support of the FMI SAR to ensure the additional objective can be effectively managed, or what further regulation may be required?

3.22 There is a practical point that should be addressed in respect of a power to direct (i.e. ensuring the Resolution Directorate of the Bank of England has engaged with the insolvency officeholder community to appreciate what administrators have to do in practice, in a manner analogous to the extensive stakeholder engagement that has supported the potential use of the Bank Insolvency Procedure, Building Insolvency Procedure and other tools under the Banking Act 2009 (as amended)).

3.23 The power to direct may itself breed uncertainty, if the BoE is left with a wide discretionary power to direct administrators. This may have an adverse impact on the market where certainty in situations of distress/failure is key, which may in turn

[4] Insolvency (England and Wales) Rules 2016, Rule 14.21, as variously applied either by reference or analogous drafting under bespoke insolvency regimes

lead to a preference for a "hands off" approach. A comparison can be drawn with the FCA's power of direction under the Investment Bank Special Administration regime, which (as far as we are aware) has never been used.

3.24 Other questions include:

- What if there is a tension between a direction from the BoE and the administrators' ability to carry on in the role/maintain its independence (especially in circumstances where the BoE is the paymaster)? Will there be a court layer whereby the court can decide on tensions between the two and effectively sanction the BoE's direction?

- Will there be a similar immunity from liability in damages in respect of action or inaction in accordance with a direction from the BoE under the FMI SAR?

- Will there be additional items to which the BoE must have regard when deciding to give a direction, that have the additional objective in mind?

3.25 It must be ensured that the BoE's intervention powers do not defeat or frustrate the purpose of the process as a whole, or the ability of the administrators to discharge their duties, and that any such tension or conflict that does arise can be quickly resolved. For example, if the aim is to empower the BoE so as to ensure that the additional objective is effectively managed, what would the solution be to any tension between a direction from the BoE and the administrators' ability to carry on its role/maintain its independence (especially in circumstances where the BoE is funding the administration – see below)?

3.26 In the event of a clash between the respective roles, the supremacy of one or the other would have to be established via an independent backstop, such as the courts. However, this is obviously problematic where the court is called on to decide on matters which may impact the systemic economy.

3.27 The issue of funding of the administrators and the process should be considered, and if the funder is the BoE, the obvious tensions with its desire to drive the process. Typically, funding such processes is contingent on either there being sufficient monies in the estate, or the assistance of the Financial Services Compensation Scheme. Consideration might be given to ensuring that BoE's level of oversight is not connected with the level of funding, and that those two functions as far as possible can operate independently, to ensure the administrators are driven by their statutory obligations and the objectives first and foremost, without concern for their independence being curtailed or fettered by concerns as to whether the steps they are taking meet with the BoE's day to day approval (as opposed to any formalised intervention by the BoE to which the administrators would be bound to have regard).

Q4 – Do you have any comments on the intention to require the Bank of England to consult with the Financial Conduct Authority prior to seeking an administration order or directing administrators where regulatory overlaps may occur?

3.28 The rationale for prior consultation is clear but in practice it will need to be designed to ensure there are no delays in effecting an appointment as a result (which, experience indicates, may typically arise over a single "resolution weekend" requiring an appointment to be made between close of markets on a Friday and reopening on a Monday). Similar measures to those that exist, for example, between regulators to support the orderly appointment of administrators under the Investment Bank Special Administration Regime in relation to 730k firms (where the prior consent of the Bank of England is required to seek an administration order for an insolvency process otherwise initiated by or closely overseen by the FCA) will be needed.

3.29 In terms of the power of direction, as noted above the challenge for the Bank of England and FCA will be to ensure that the circumstances for such direct intervention are sufficiently well-understood at the outset of an insolvency process to ensure the risk of regulatory intervention does not prevent the officeholder from discharging their functions quickly and in pursuit of the identified additional objectives.

3.30 The Memorandum of Understanding (MOU) that exists between the Bank of England, the FCA and the Payment Systems Regulator could be used as a basis to support this.

4. Point of contact

4.1 Should you have any queries or require any clarification in respect of our response, please feel free to contact our chairperson or any of the members of the working group set out below:

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Other working group members:

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4.2 Other members of the Insolvency law Committee are listed here:

https://www.citysolicitors.org.uk/clls/committees/insolvency-law/insolvency-law-committee-members/