



Resolution arrangements for investment banks

HM TREASURY CONSULTATION

HM Treasury has published a consultation paper setting out tentative proposals for changes to resolution arrangements for investment banks. Responses are invited by 16 March 2010. This briefing outlines the main proposals.

Introduction

HM Treasury's first publication on the subject of resolution arrangements for investment banks was a discussion paper issued in May last year, which outlined its initial thinking on ways to improve these arrangements. It has now published a consultation paper setting out tentative proposals for change. Responses are invited by 16 March 2010. A further document with firm proposals and draft legislation is to be published later in the year. In addition, the Financial Services Authority (FSA) is expected to publish a consultation paper on client money and client assets 'early' in the year.

The proposals in the consultation paper can be grouped into three main categories: ensuring an orderly resolution process; improving arrangements for client money and assets; and improving arrangements for reconciling counterparty positions. There are also one or two miscellaneous proposals on other issues.

Ensuring an orderly resolution process

These proposals are concerned with two main issues. First, some changes are proposed to improve the administration regime by making some adjustments to the objectives of an administration and to the potential liabilities of administrators and directors. Second, there are proposals designed to ensure that firms make adequate preparation for the possibility that they may get into severe difficulties or collapse.

A special administration regime for investment banks

At present, the administration regime applicable to investment banks is the same as that for ordinary commercial companies. The government considers that some adjustments need to be made to take into account the special circumstances of investment banks (in the same way that the Banking Act 2009 creates a special regime for the resolution of deposit-taking institutions). Particularly relevant here is the potential impact of an administration of an investment bank on the stability of the financial system generally, coupled with the complexity of these firms' financial operations and their role as trustees of client money and assets. The proposed new administration regime would apply to UK incorporated firms that, broadly, hold client assets and deal in investments as principal and agent. For deposit-taking institutions, it is not clear what the relationship would be between this regime and the bank administration procedure under the Banking Act 2009.

It is proposed that administrators of these investment banks should have special objectives. These would require an administrator to:

- prioritise the return of client money and assets;
- provide essential services and facilities to businesses sold off by the failed firm;
- engage in a timely fashion with payment and settlement systems, other market infrastructure bodies and the authorities; and
- wind up the firm in the interests of creditors as a whole.

To enable administrators to act rapidly and with greater freedom, they would have a special defence from personal liability. The firm's directors would also have a special defence from liability to enable them to implement resolution plans and address potential obstacles in the context of the pre-insolvency resolution process.

Requiring firms to manage for failure

The proposals in this area build on work already under way with some banking groups to ensure that firms have recovery and resolution plans (sometimes referred to as 'living wills'). The main ideas are that a firm should:

- have a 'business resolution officer', a board-level officer of the firm, charged with special responsibilities (during both business-as-usual and distress situations) relating to firm-level resolution actions;
- adopt an 'investment firm resolution plan' specifying the actions it should plan for, both pre- and post-insolvency, to enable its business to be wound down in an orderly manner;
- produce 'business information packs' containing information on the firm's business and structure to enable an administrator rapidly to understand a firm's situation and to facilitate the settlement of trades or the return of client assets in a timely manner; and
- establish continuity-of-service measures for staff and suppliers, and sufficient ring-fenced liquid reserves to pay them, so that essential functions can continue in an administration.

Improving arrangements for client money and assets

One of the most acute problems in the Lehman Brothers administration has been the long delay in returning client money and assets to the clients to whom they belong. The highly complex realities of a large cross-border investment banking business have in practice trumped the supposed legal certainties of ownership. Given the importance to UK financial markets of the client money and client assets concepts, the government is making proposals designed to ensure that clients' reasonable expectations of recovery of their money and assets would be met in future.

The proposals cover a number of areas.

- *Risk warnings*: the FSA is being asked to consider whether a firm should be required to give certain risk warnings if it wished to be able to rehypothecate a client's assets or even to hold a client's assets in an omnibus account at custodian level. More generally, firms would need to be more transparent about any risks to the protection of client money and assets.
- *Clarifying client entitlements*: the government is considering whether to clarify how shortfalls in omnibus accounts should be borne; in particular whether it should be made clear that all clients should suffer in proportion to their entitlement.
- *Daily client reporting by prime brokers*: the FSA has been asked to consider imposing additional client reporting obligations on prime brokers, relating to net and gross client positions, the extent of any rehypothecation of client assets and the location of client money and assets. There are related proposals to do with increased record-keeping requirements.
- *Improving regulatory oversight*: firms would need to expand their disclosure to the FSA regarding the holding of client money and assets. The FSA is considering clarifying the scope of controlled function 29 (a senior management function) to ensure that personnel in charge of directing client assets are required to be FSA approved persons.
- *Limiting the rights of the firm and its custodians*: firms' ability to transfer client money to affiliates and jurisdictions would be subject to limitations where this would be incompatible with FSA client money protections. Custodians would not be permitted any lien or right of retention over a client account and would be prohibited from setting off obligations owed by the firm against such an account.
- *Pooling arrangements*: firms would have to have the capacity to divide client money into different pools by reference to the type of business to which the money relates. The idea is that money relating to more straightforward business (eg cash equities) would be less at risk of shortfalls than money relating to more complex business (eg derivatives).
- *Bar dates*: a statutory scheme would be created to set a date by which claims to client money would need to be received by an administrator.

- *Bankruptcy-remote special purpose vehicles*: the government welcomes the steps being taken by a number of firms to establish bankruptcy-remote vehicles for holding client assets and is consulting on whether and, if so, how it should support these initiatives through regulatory or legislative measures.

Reconciling counterparty positions

Another serious problem encountered in the Lehman administration concerned the large number of securities transactions that had been executed but had not yet settled when the administration began. Uncertainty over whether these trades would in fact settle left many clients and counterparties unsure of their market exposure and unable to hedge their positions effectively. The main proposals in this area are as follows.

- *Statutory protection for multilateral trading facility default rules*: the government proposes to extend protections similar to those in part 7 of the Companies Act 1989 to multilateral trading facilities, to allow their default rules to take precedence over the insolvency law rules that would otherwise apply.
- *Market protocol for over-the-counter (OTC) cash equities trades*: the government is consulting on a number of issues relating to the protocol that has been developed by the Association for Financial Markets in Europe. The protocol provides a standard set of default rules for OTC cash equities trades.
- *Segregation of client business*: it is proposed that central clearing counterparties should be expressly required to offer member firms the ability to segregate client business from house business. The government appears not to favour mandatory segregation of client from house business at central clearing counterparty level.
- *Freezing of pending settlement instructions in CREST*: the paper explains the proposed new approach to be adopted by Euroclear (as the operator of the CREST system) for dealing with the insolvency of a CREST participant. Essentially, all pending settlement instructions in the system relating to that entity would never settle. They would ultimately be removed from CREST altogether, without the need for the input of matched 'delete' instructions from the CREST participants. The paper asks for views on Euroclear's proposal.

- *Market action to address contractual uncertainties*: the government notes that a 'battle of the forms' frequently takes place between investment managers and sell-side firms when trying to agree on terms of business, often resulting in contractual uncertainty. The government intends to monitor this issue. The paper asks whether government action is required to address contractual terms issues and, if it is, how it might best do so.

Miscellaneous proposals

- *Client assets trustee*: the government proposes that a new type of insolvency officer, a 'client assets trustee', be created. A client assets trustee would be appointed to work alongside the administrator, with a specific mandate to uphold the interests of clients for whom the firm is holding money and other assets on trust and to speed up the return of those assets to their owners.
- *Client assets agency*: consideration is being given to establishing a client assets agency, which would take over some responsibility from the FSA for the regulation and supervision of systems and controls relating to client money and assets, and play a role in an administration.
- *Termination of OTC derivatives contracts*: the government notes the difficulties caused to an administrator by the provision in the ISDA Master Agreement that allows a non-defaulting party to suspend payment of its obligations to the defaulting party (without requiring it to call an event of default) for an indefinite period. The government hopes that a market solution can be found to preserve the intended benefit of this provision to the non-defaulting party while providing sufficient certainty to an administrator. However, it leaves open the possibility of regulatory or legislative action should a market solution not be found.

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For further information please contact

Michael Raffan
T +44 20 7832 7102
E michael.raffan@freshfields.com

Mark Kalderon
T +44 20 7832 7106
E mark.kalderon@freshfields.com

David Rouch
T +44 20 7832 7520
E david.rouch@freshfields.com

James Smethurst
T +44 20 7832 7478
E james.smethurst@freshfields.com

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