

# Developing effective resolution arrangements for investment banks

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May 2009



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# Executive summary

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Over the past two decades the UK has become one of the main international centres for investment banking. London's world-class reputation as an investment banking hub has been built on a strong and predictable legal system, a skilled international workforce, and an appropriate, and robust, regulatory framework. The Government is committed to building upon these strengths, and cementing the UK's reputation as a world-class venue for all types of investment banking business.

The Government recognises that these are challenging times. London, like all major financial centres, was shaken by the collapse of Lehman Brothers in September 2008, and the events that followed. The Government's response has been two-fold, starting with the action taken in the autumn of last year to stabilise the financial system and to limit, as far as possible, the wider impacts from the failure of Lehman Brothers. Looking to the future, the Government is committed to implementing reforms that will enable an easier resolution of a failing investment bank, should any such event ever happen again.

This report lays out the Government's initial thinking as to the reforms which may need to be considered in developing effective resolution arrangements for investment banks. It responds directly to the issues that were highlighted in the Lehman Brothers case; including the treatment of investment banking clients after default, the future of their assets, and the treatment of their open or unreconciled trading positions. It also examines what can be done to make the process of insolvency itself more effective, and limit the damage that may be done by a failing investment bank.

The reforms that are being considered will aid in the renewal of the UK financial services sector. They demonstrate the Government's commitment both to financial stability, and to the future of London as an investment banking hub. In making the case for reform, the UK is playing a leading international role, and is addressing the difficulties highlighted by the failure of Lehman Brothers as promptly and effectively as possible.

In order to address the very substantial technical challenges that these issues raise, the Government is working with a specialist Advisory Panel of investment banking, insolvency, legal and other experts, as well as the Financial Services Authority and the Bank of England. The Government, in consultation with the Advisory Panel, is considering whether any changes to market practice, regulation or legislation would help any future failures in the investment banking sector to be dealt with more smoothly, providing benefits to financial stability and supporting London's position as a global financial centre.

This report presents a high-level overview of the issues under consideration, and will be followed by more detailed consultation as appropriate. The Government welcomes responses to the issues and questions raised in this paper by 10 July 2009.



# 1

## Introduction

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**1.1** The UK, and particularly London, serves as one of the pre-eminent international centres for investment banking and related services. Around half of European investment banking activity takes place through London and, along with New York, London is the global leader for the provision of investment banking services. According to research published by International Financial Services London;

“History and geography have played an important part in establishing the UK’s leading position [in investment banking] in Europe and its global importance.

But its continued leadership is a function of its trading culture, skills base and language. London can offer greater depth and breadth of expertise than any other financial centre.”<sup>1</sup>

**1.2** The UK’s robust and flexible legal and insolvency regimes are two of the most important foundations underpinning the success of the UK financial services sector and its role as an international centre for investment banking. In particular, the fact that the UK insolvency regime does not discriminate between domestic and international creditors remains an area of significant competitive advantage.

**1.3** The Government is committed to maintaining these advantages, and building upon London’s success as a global investment banking centre. In doing so it is important that the Government, in collaboration with the Financial Services Authority (FSA) and the industry itself, is able to take appropriate action, and respond quickly and effectively to any concerns that may emerge with regard to the UK regime.

**1.4** The recent turbulence in financial markets has highlighted challenges for the providers of investment banking services and their clients, as well as governments and regulators, the world over. A particular set of challenges has emerged in the context of the insolvency of such firms, including with respect to the manner in which administrators and other insolvency officials deal with open positions in the market and the return of client assets once the failing firm has entered insolvency. Market participants have questioned the ability of insolvency regimes, in all countries, to respond to the unique challenges posed by the failure of large complex financial institutions, particularly global investment banks.

**1.5** It is vital that the Government responds actively to these challenges, by considering whether the UK insolvency regime could be further strengthened, by establishing appropriate measures to deal with investment banking failure, and working with our international partners to ensure cooperation when dealing with the failure of major cross-border firms.

**1.6** This paper provides the first step, in highlighting the Government’s initial thoughts on the main areas where reforms could be considered in relation to insolvency law, regulation and

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<sup>1</sup> Source: IFSL Research. Banking 2008

market practice. This work has been informed by advice and input from an Advisory Panel of industry experts. The reforms proposed will aid the further development of the UK financial services sector; they demonstrate the Government's commitment both to financial stability, and to the future of London as an investment banking hub.

**1.7** The Government has decided to open these questions to wider consultation at a relatively early stage in order to give market participants the fullest opportunity to contribute to possible solutions that achieve the necessary protections while maintaining flexibility, and the competitiveness of the UK as a place to do investment banking business.

## Background

**1.8** Some of the challenges identified in Paragraph 1.4 above with regard to insolvency provisions for investment banks have been highlighted by the failure of Lehman Brothers, specifically its UK arm, Lehman Brothers International (Europe) (LBIE). Prior to its failure, Lehman Brothers was the fourth largest US investment bank; it operated an international affiliate structure, with LBIE, the UK arm, managing European investment banking operations for the Group.

### **Box 1.A: Failure of Lehman Brothers International (Europe) (LBIE)**

At 12.30am on 15 September 2008, LBIE was informed by its US parent company Lehman Brothers Holding Inc. (LBHI) that it was preparing to file for Chapter 11 bankruptcy protection under US law. Overnight, preparations were made for a number of the Lehman Brothers Group companies in the UK to seek the protection of an administration order. At 7.56am on 15 September, administration orders were made in respect of each of the Lehman Brothers' UK Companies. Later that day, LBHI announced that it had filed for Chapter 11 bankruptcy protection in the US. Lehman Brothers Inc (LBI) (the investment bank operation arm in the US) was supported by the US financial authorities for a further five days, before the Securities Investor Protection Corporation (SIPC) initiated its liquidation on 19 September 2008.

**1.9** The Lehman Brothers' failure has raised important questions, in all jurisdictions, about the implications of the insolvency of investment banks for market participants, particularly in relation to trading, clearing and settlement, and to the return of client assets. The longer-term response to the events of September 2008 requires regulatory authorities and governments in all relevant jurisdictions to consider what changes may be required to their regimes as a result.

**1.10** The Government is therefore conducting a review, in conjunction with an Advisory Panel of industry experts (described in Paragraph 1.32) to address the issues highlighted by the failure of Lehman Brothers, particularly those laid out in Paragraphs 1.13 to 1.16. This review is not designed to respond to the specific issues relating to the Lehman Brothers' insolvency, but rather to address the policy questions it has highlighted as they relate to the resolution of investment bank failure more generally. The scope of this work is discussed in Paragraph 1.36 to 1.39.

**1.11** The fact that the Government is conducting this work should not reflect on the administration of LBIE itself. The Government welcomes the fact that there have been significant steps forward in that administration, as laid out in Box 1B below.

**1.12** In addition, while the failure of Lehman Brothers may have highlighted some of these issues, this paper is not simply a response to the particular details of that case. Rather, it takes a wider overview of the industry as a whole, and seeks to identify where lessons learned from Lehman Brothers could be applied across the board. The Government is aware that some issues highlighted by the Lehman Brothers' failure may have been particular to Lehman Brothers and is not looking to enforce a one-size fits all approach to the detriment of commercial flexibility.

#### **Box 1.B: Administration of Lehman Brothers International (Europe) (LBIE)**

On 14 April 2009, PricewaterhouseCoopers (PwC) published a six-month progress report on the administration of LBIE. The stated objective of the joint administrators is to "achieve a better result for LBIE's creditors as a whole than would be likely if LBIE were wound up (without first being in Administration)." To date, the administrators have:

- returned 46% (£12.2bn) of client assets;
- sold the equities business to Nomura, saving 2,400 jobs;
- identified and valued the majority of around 130,000 existing OTC derivative contracts;
- gained control over the assets of LBIE and its clients, including over \$35.5bn in securities;
- recovered \$8.7bn to date, held as cash on deposit or investments;
- formed policies for handling the estimated 839,000 pending and failed trades, including deleting many from exchanges; and
- developed a 'Scheme of Arrangements' for the return of client assets

Source: Lehman Brothers International (Europe) In Administration – Joint Administrators' progress report for the period 15 September 2008 to 14 March 2009

## **Addressing the implications for the UK**

**1.13** The failure of Lehman Brothers, and specifically the failure of its UK arm, LBIE, and its being placed in administration, highlighted two areas of possible difficulty with the UK insolvency regime: first, around trading, clearing and settlement; and second, around the return of client assets. Each of these is significant and needs to be addressed in order to maintain financial stability and protect the reputation of the City of London as a world-class venue for investment banking business.

**1.14** The trading, clearing, and settlement issues relate to the ability of counterparties to determine the status of their outstanding positions in the event of a firm's default. Following the failure of LBIE, counterparties were unclear as to their contractual positions and the status of outstanding trades, including whether or not they would go on to settle. The Government takes these concerns seriously, while noting that they are not unique to the London market.

**1.15** The client asset issues relate to the ability of clients to secure a prompt return of their assets from LBIE. At present there is no special duty on the administrators to prioritise the return of such assets, some of which may have been subject to third party rights of use (rehypothecation). As a result, there has been a perceived lack of clarity over the ability of the UK regime to protect clients in such an insolvency situation.

**1.16** Taken together these concerns, highlighted by the Lehman Brothers' case, could, if not addressed, damage confidence in the UK as a place to conduct investment banking business. The intention of this paper is to identify areas where such concerns are justified and indicate the Government's initial thinking as to how to address these.

## **Challenging misconceptions about the UK regime**

**1.17** The Government takes these issues extremely seriously, and intends for the UK to take a lead in addressing them. But the Government does not believe that the UK regime has performed more poorly in the Lehman Brothers' case than regimes in comparable jurisdictions.

**1.18** It is important to realise that the failure of a global investment bank was not something that had been anticipated in any jurisdiction, and no insolvency and regulatory regime, in any country, was fully adapted to address it. Most insolvency regimes, by contrast, have focused on the insolvency of clients rather than their investment banks.

**1.19** In many ways the UK insolvency process offers significant advantages, in, for example, not making distinctions between domestic and overseas creditors. The Government, and the Advisory Panel, are of the view that the market commentary which has suggested that the UK regime has operated less effectively than that of the US in the Lehman Brothers' case is misconceived (see Box 1.C).

**1.20** In this regard, it must be remembered that some of the characteristics of the UK regime that distinguish it from regimes in other jurisdictions may in themselves be factors in London's attractiveness as a global financial centre. If London is to continue to act as an international centre for investment banking, it would not be appropriate to emulate resolution and compensation regimes which distinguish between domestic and international creditors as in the US, for example. In addition, it should be noted that some of the legal and other restrictions placed on investment banks in other jurisdictions are more onerous or prescriptive than those that apply in the UK, and are likely to result in greater costs and less flexibility for clients and customers.

**1.21** The Government believes that the UK administration regime (and the insolvency system more generally) is robust and fit for purpose. This paper does not therefore seek to discuss altering the fundamental principles of UK insolvency law. Rather, it seeks views on a discrete area where normal insolvency procedures could be improved upon. It also explores whether some of the issues relating to trading, clearing and settlement and to client assets could be addressed through market and regulatory measures.

**1.22** This paper provides further clarity around the existing regime in Chapters 2 to 4. The Government will continue to work with the Advisory Panel to address any existing misconceptions around the UK insolvency regime and procedures for the failure of firms engaged in investment banking activities.

### **Box 1.C: Addressing misconceptions – how the US and UK insolvency regimes have dealt with the Lehman Brothers' failure**

There has been some market commentary to the effect that customer protections and insolvency arrangements in the US have been operating more effectively than the UK arrangements in the context of the failure of Lehman Brothers. The industry experts assembled through the Advisory Panel have been clear that this perception is misconceived.

Both the UK and the US insolvency regimes have significant strengths, based on clear expectations as to the rights and responsibilities of their respective insolvency practitioners, creditors and clients. At the same time however, it is naturally the case that the regimes operating in the two jurisdictions contain significant areas of difference, reflecting the different legal arrangements in both countries. Consequently the administration or liquidation of an insolvent firm will never proceed along identical lines in both jurisdictions, and direct comparisons between them are unlikely to be useful.

This is further complicated by the fact that in the US, as a result of various pre-emptive actions, Lehman Brothers' US customer assets and money were, to a large extent, protected from becoming trapped in the liquidation, and hence not 'put to the test' under the US insolvency regime. Chapter 4 of this paper considers similar 'pre-failure' steps that could be taken in the UK, but it is important to note that the two processes are not directly comparable.

The Advisory Panel has also taken the view that it is too early to determine the general effectiveness of the insolvency procedures in any of the jurisdictions dealing with the failure of Lehman Brothers' affiliates. In the UK, the administrators, Pricewaterhouse Coopers (PwC), have gone on record to indicate that the Lehman Brothers' insolvency may be the most costly and complex in history. The final outcomes for clients and creditors in the UK and the US are impossible to predict at this stage. There is no reason whatsoever to believe that clients or creditors of the UK arm of Lehman Brothers will be materially disadvantaged on the basis of the regime applicable in the UK compared to their counterparts in other jurisdictions conducting comparable business.

The Government is committed to working with the Advisory Panel and other industry experts, to explain, and where appropriate dispel, any of the misconceptions around how the US and UK regimes have operated with regard to the Lehman Brothers' failure.

## **Setting clear objectives**

**1.23** It is important that misconceptions with regard to the UK insolvency regime be addressed. However, as mentioned in Paragraph 1.13, the Government recognises that there are a number of real issues with regard to the UK system of insolvency, as it applies to investment banks, which could benefit from reform.

**1.24** The Government has established a set of four high-level objectives to guide the reform process. These are:

- to deliver policy outcomes that ensure financial stability and market confidence, as well as the international competitiveness of the UK;
- to identify the precise nature of existing difficulties with regard to the current arrangements for the insolvency of firms conducting investment banking activity;

- to identify core principles for an effective, proportionate and balanced regime applying to such firms holding, managing, or directing client assets; and
- to determine the legislative, regulatory and market solutions which may be necessary to achieve this.

**1.25** In addition, the Government, in consultation with the Advisory Panel, has laid out specific sets of objectives pertaining to the trading, clearing and settlement and client assets and monies issues discussed in Chapters 2 and 3 respectively. These objectives are laid out in the relevant chapters and in Paragraphs 1.54 and 1.57.

## **Taking appropriate and balanced action**

**1.26** In delivering these objectives the Government is committed to taking appropriate and balanced action, on the basis of a full consideration of the costs of any changes to insolvency law or practice which may be proposed. It is intended that the issues raised be addressed through a combination of market practice, changes to regulation (for the FSA to take forward) and legislative steps, with legislation used only where necessary.

**1.27** Clearly, each of these approaches has particular merits, and it is expected that a combination of any or all of these tools may be appropriate. The Government has made particular commitments to legislate for changes to insolvency law only where strictly necessary, and will seek market and regulatory solutions where possible.

**1.28** The Government took powers in the Banking Act 2009 to make regulations with regard to the insolvency of investment banks. The powers in the Banking Act 2009 allow the Government to lay secondary legislation within a period of two years of the Act coming into force. This time limitation was introduced in order to provide market participants with certainty that whatever changes to insolvency law may be made through this review process will be made within this two year period, or not at all (unless the Government enacts further primary legislation).

**1.29** In making any changes to insolvency law, or recommending changes in market practice or regulation, the Government is aware of the need to consider all of the groups who will be affected. Changes will affect firms offering investment banking services themselves, but also creditors, counterparties and any users of the capital markets who benefit from a low-cost execution of business (which would include, for example, corporates that benefit from having a liquid market in their shares and bonds).

**1.30** The Government is also conscious of the need to provide for a regime in which the level of protection for clients and creditors is balanced with a consideration of cost implications, and maintains a sufficient degree of autonomy for sophisticated counterparties to manage their risk by contractual arrangement.

## **An open and collaborative policy-making process**

**1.31** The Government acknowledges the substantial technical difficulties in amending such a complex area of the UK insolvency regime, and notes the wide range of stakeholders who would potentially be affected. Therefore, as announced in the Budget, and the November 2008 Pre-Budget Report, the Government has established a group of experts, to constitute an Investment Banking Advisory Panel.

**1.32** The Advisory Panel is comprised of industry practitioners (from both the 'buy' and 'sell' sides), insolvency experts, legal specialists and representatives from the Tripartite Authorities.

Two smaller Working Groups have been convened to drive forward the two main work-streams set out in Chapters 2 and 3 of this document. The Advisory Panel is providing advice to the Government on the technical aspects of the reforms under consideration, and has provided input into the policy proposals outlined in this document.

**1.33** The Government hopes that this open and collaborative policy-making process will lead to robust outcomes which reflect the needs of market participants and secure the public interest in both financial stability, and London's competitive position as a global investment banking hub.

## **A broader reform agenda**

**1.34** The Government's work with regard to developing effective resolution arrangements for investment banks should be seen in the context of the broader range of steps the Government has taken forward to protect and enhance the financial stability of the UK. A number of important steps are described below:

- the Banking Act 2009 – this addressed the immediate need for a comprehensive regime for dealing with bank failures and other important aspects of financial stability and depositor protection;
- the Turner Review of financial regulation – in October 2008 the Chancellor asked Lord Turner, the Chairman of the FSA, to make recommendations on the changes in regulation and supervisory approach needed to create a more robust banking system for the future. The Government welcomes the Review's recommendations and the accompanying FSA Discussion Paper, published on 18 March 2009; and
- progress in the G20 and other international fora – many of the regulatory changes necessary will need international agreement. The Government is leading the debate on the future of financial markets. Leaders and Finance Ministers of the G20 met in London on 2 April 2009 and agreed a broad range of measures to strengthen the financial system. Further progress will be needed to take this forward. The UK has also contributed to progress in this area within other international fora, such as the G7 and the EU.

**1.35** This paper complements other work being done in this area. In a forthcoming paper the Government will describe its approach to the future of financial markets and set out the actions necessary to achieve it. The Government will seek financial markets, in the UK and internationally, that:

- are open and competitive, meeting the needs of all constituents in society and the wider economy efficiently and fairly;
- enjoy and inspire the trust and confidence of all users, including consumers;
- are subject to stronger regulation that reduces the likelihood of damaging market and institutional failures; and
- have effective mechanisms for dealing with the failure of financial institutions when, nevertheless, they do occur.

## **Scope of proposed reforms**

**1.36** As discussed in Paragraph 1.24, the reforms proposed with regard to investment bank insolvency have four distinct objectives. In working towards these, the Government is considering a wide range of possible steps, which are laid out in Chapters 2 to 4. The scope of

the review is being kept deliberately broad at this stage, in order to facilitate the identification of the full range of steps that may need to be investigated further.

**1.37** While this paper draws on the issues which have been highlighted as a result of the LBIE administration, it will be important to consider to what extent the issues arising from that administration were particular to Lehman Brothers rather than indicative of sector practice as a whole. The scope of this work, while informed by Lehman Brothers' failure, is not restricted to considering only those issues that arose directly out of that failure.

**1.38** It is intended that the reforms proposed in this paper, and through the work to follow, will apply to investment banks holding, managing or directing client assets. The Government, following advice from the Advisory Panel, has determined that it is not appropriate at this stage to define the scope of the work more narrowly. Rather, it is intended that the Government should continue to consider a broad range of difficulties emerging from the Lehman Brothers' failure and related issues connected to the insolvency of investment banks and determine the institutional scope of any reforms on this basis.

**1.39** Investment banks tend to operate in multiple jurisdictions (as discussed in Paragraphs 1.44 to 1.45) and through a number of affiliated companies that are managed, for credit and liquidity purposes, as a global business. Inevitably this complicates the analysis as to how such a bank's business is to be dealt with in a particular jurisdiction when it is in insolvency proceedings and so any proposed reforms need to consider how best to reflect this commercial reality, particularly with regard to affiliates and branches.

### **Interaction with the Banking Act 2009 and other insolvency regimes**

**1.40** As discussed in Paragraph 1.27 above, the Government does not intend to introduce legislation pertaining to investment bank insolvency unless there is a clear case for doing so. This is particularly important given the existing complexity pertaining to special insolvency regimes.

**1.41** Any proposals in this paper, and any policy outcomes that may emerge through the course of the subsequent consultation process, need to be carefully considered in the light of existing insolvency procedures, both normal insolvency law relating to investment banks as laid out in the various pieces of existing legislation (see Box 4.A) and special provisions as laid out in the Banking Act 2009.

**1.42** Members of the Advisory Panel have stressed the need for clarity as to how any special regime for dealing with investment banks would interact with the special regime for the insolvency of deposit taking banks as laid out in the Banking Act 2009, particularly where an institution conducts both investment banking and retail banking activities.

**1.43** The Government will also ensure that any steps taken forward through this process interact effectively with any changes that may occur as a consequence of a subsequent review of the insolvency provisions in Part 7 of the Companies Act 1989.

### **International and European dimensions**

**1.44** The Government recognises that the business and operations of any investment bank are likely to be international in nature. The firm may be part of a group of companies with its parent in an overseas jurisdiction with different regulatory and insolvency laws and procedures. Such a firm is also likely to use custodians and sub-custodians located in other jurisdictions and, at the

time of failure, it is possible that these custodians may be subject to their own insolvency or pre-insolvency processes.

**1.45** It is therefore necessary to consider any proposed UK solutions in respect of a failing investment bank in an international context. In particular, the Government will be giving full consideration to:

- the recognition (or otherwise) of any UK solutions in other jurisdictions where the investment firm may have dealings; and
- the interrelationship between any UK insolvency or pre-insolvency proceedings and any such proceedings that may be commenced in other jurisdictions.

**1.46** In terms of recognition, an investment bank is not covered by any European cross-border insolvency legislation. The EC Regulation on Insolvency Proceedings (EC) No 1346/2000 excludes investment undertakings that provide services involving the holding of funds or securities for third parties (art 1(2)). Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions only applies to licensed deposit-taking institutions. Therefore there is no EC Directive or Regulation that applies to the insolvency of investment banks. It is possible that an investment bank may be covered by a particular jurisdiction's implementation of the UNCITRAL<sup>2</sup> Model Law on Cross-Border Insolvency but, to date, only a limited number of European jurisdictions have implemented this law and, in any event, this does not provide for the automatic recognition of all aspects of the insolvency proceedings in question.

**1.47** The Government notes that the European Commission has recently announced that it is proposing an EU-wide legal framework for the holding and disposing of client securities and for the mandatory regulation of safekeeping and administering of securities. This work replicates in many respects the draft international convention being prepared by UNIDROIT to harmonise the treatment of securities held through an intermediary. Such initiatives will address certain issues affecting the segregation of client securities, the treatment of shortfalls in client accounts, and the protection of client securities from the account provider's insolvency. Similarly, one of the recommendations in the de Larosière Report on Financial Supervision in the EU<sup>3</sup> proposes tighter supervisory control over the independent role of depositories and custodians. The Commission's proposed framework for managers of alternative investment funds also contains similar provisions. The Government will continue to engage actively with the Commission on all of these areas of work.

**1.48** At present however there is no cross-border framework, binding across the European Union or European Economic Area, that provides for the automatic recognition of certain types of insolvency proceedings commenced in the 'home' Member State (i.e. the principal place of authorisation of the investment undertaking). Instead, any insolvency officeholder appointed in relation to an investment firm in the UK would have to seek recognition of the UK proceedings in other relevant jurisdictions (as the administrators of LBIE have done in France) and it would be a matter for the discretion of the overseas court as to whether such recognition was granted. There is also nothing to prevent parallel or ancillary insolvency proceedings being commenced, in relation to a UK authorised investment firm, in another jurisdiction, which could clearly lead to cross-border complexities.

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<sup>2</sup> United Nations Commission on International Trade Law

<sup>3</sup> [www.ec.europa.eu](http://www.ec.europa.eu)

**1.49** As there is little that can be done in this review (from a UK law perspective) to address these international concerns, any solutions that the Government takes forward will be limited to UK authorised investment firms. That said, the Government is firmly of the view that the fact that some of these issues may ultimately be addressed in EU or international law or best practice does not remove the need for the UK to confront the current challenges on a national level.

**1.50** The Government intends to monitor, and engage actively in, where appropriate, any cross-border initiatives in relation to investment firms, to ensure that any proposed UK solutions are neither inconsistent with nor cut across international developments.

## **Structure of this paper**

**1.51** The objective of this paper is not to provide details of concrete policy recommendations for consultation, but to highlight some of the areas where the Government considers that reform could be explored. Accordingly Chapters 2 to 4 highlight general areas of policy thinking but do not propose firm policy solutions; the Government's intention is to publish these in later consultation papers.

## **Trading, clearing and settlement**

**1.52** Chapter 2 considers issues around the trading, clearing and settlement problems associated with the insolvency of broker-dealers. In particular it investigates issues around the settlement of open cash equity trades (including the ability to process to failure or secure match-deletion in the event of insolvency) and issues around open derivatives positions, whether exchange-traded or over the counter (OTC), in the event of an insolvency.

**1.53** The specific objectives laid out in Chapter 2 are:

- protecting the diversity and choice of trading, clearing and settlement methods for market participants;
- ensuring clarity, and building an environment in which the reasonable expectations of market participants with regard to trading, clearing and settlement are consistently matched with outcomes;
- ensuring that clear and flexible contractual arrangements can be applied consistently in a manner which secures legal certainty with regard to trading, clearing and settlement; and
- developing appropriate market and regulatory responses to the technical challenges surrounding uncertainty with regard to the trading, clearing and settlement of trades not executed on recognised exchanges in the event of insolvency proceedings.

**1.54** The Government has received guidance on Chapter 2 from a specialist working group comprised of expert members of the Advisory Panel. The working group is considering what mix of market, regulatory and legislative steps may be appropriate in addressing the objectives highlighted in Paragraph 1.53.

## **Client assets and monies**

**1.55** Chapter 3 considers issues around the prompt return of client assets in the event of investment bank insolvency. Amongst other issues, it considers cases where effective segregation has not occurred, cases where complex liens or set off arrangements exist, and cases where rehypothecation has occurred.

**1.56** The specific objectives laid out in Chapter 3 are:

- ensuring clarity with regard to the ways in which client assets and monies are treated on insolvency, and addressing misconceptions;
- facilitating the identification and legal categorisation of client assets and monies following the commencement of insolvency proceedings and the legal categorisation of a client's rights in respect of those assets and monies;
- improving the speed with which client assets and monies are returned to investors; and
- ensuring that sufficient flexibility is maintained in order to enable investors and brokers to arrive at mutually acceptable outcomes, and to ensure that any new regime is both 'future-proof' and has no substantial negative impacts.

**1.57** As with Chapter 2, the Government has received guidance on Chapter 3 from a separate specialist working group comprised of expert members of the Advisory Panel. The working group is considering what mix of market, regulatory and legislative steps may be appropriate in addressing the objectives highlighted in Paragraph 1.56.

## **Achieving effective resolution**

**1.58** Chapter 4 considers proposals related to the insolvency process itself. The Government believes that there are a number of steps that could be taken, in market and regulatory practice, and potentially through amendments to existing insolvency law, which may enable a more timely and effective response in the event of any future failure of an investment firm. These issues are cross-cutting, insofar as the effectiveness of the insolvency process itself is critical to the achievement of objectives laid out in both Chapters 2 and 3. As such, no separate sets of objectives are established in this chapter.

## **Next steps**

**1.59** The Government would welcome responses to this consultation by 10 July 2009. The Government will consider responses and publish a full consultation paper by the early autumn, outlining possible market and regulatory approaches and any proposed legislative solutions.

**1.60** The consultation period for the autumn paper will last for 12 weeks and a further round of consultation may, if necessary, take place around the end of the year. If appropriate, draft regulations may be published at this time, and, should it prove necessary, secondary legislation may then be laid. Any agreed market and regulatory solutions may come into effect at different points, subject to full consideration by market participants and the FSA, as appropriate.

**1.61** Members of the Advisory Panel have provided valuable insight into this work and the Government welcomes wider views in response to this paper to ensure that due consideration has been given to the complexities of this issue.

**1.62** The Government would welcome comments on the questions specifically raised throughout the document and also wider views on the issues being discussed. A summary of all the specific questions posed can be found in Chapter 5. Further information on how to respond to the consultation is in Annex A. Annex B contains a description of the Government's proposed approach to an impact assessment for subsequent consultation, when policy proposals will be developed more fully.



# 2 Trading, clearing and settlement

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**2.1** Any failing investment bank will be likely to have a large number of positions open at the point of entry into an insolvency procedure. These may include unsettled exchange trades, over the counter (OTC) cash equity trades, open exchange-traded derivatives positions, open derivatives contracts and other instruments. In the case of Lehman Brothers International (Europe) (LBIE), the administrators estimate that 1.5 million positions remained open at the date of entering administration.

**2.2** The implications of this are substantial. The ability of market participants in any jurisdiction to achieve clarity into their open positions and hedge their exposures, is critical to a well-ordered and effective financial system. The Government intends to build upon London's existing strengths by addressing these issues as promptly and effectively as possible.

**2.3** This chapter therefore highlights some of the areas where further review may be needed to provide improvements to the existing regime with regard to trading, clearing and settlement in order to address these difficulties. The chapter considers issues around the trading, clearing and settlement of open cash equity trades (including the ability to secure match-deletion) in the event of insolvency proceedings, as well as issues around open derivatives positions (whether exchange traded or OTC).

**2.4** The Government's objective is to ensure that counterparties can be confident that positions held with an insolvent investment firm can be resolved as soon as is reasonably possible, and in a manner that provides for clear expectations as to how, and over what time-period, such resolution will occur. The intention is that this should be achieved while having regard to the ability of market infrastructure providers to manage an insolvency efficiently and according to their own rules.

## Background – improving choice

**2.5** The number and variety of venues on which it is possible to execute trades in equities has increased noticeably over the past few years. While an increased choice of venues has led to greater competition and efficiency, trading is now fragmented across regulated markets (RMs) and multi-lateral trading facilities (MTFs). In addition, other venues facilitate executions at prices referenced from those RMs or MTFs, including those operated both by exchanges and investment firms and OTC trading more generally.

**2.6** Competitors to the traditional stock exchanges have been present in London for years, but the recent step change has many causes. An increased demand for faster and cheaper trading, and the ready availability of technology to define and support execution platforms were significant drivers. Many commentators also acknowledge the introduction of the EC Markets in Financial Instruments Directive (MiFID) as being a key component to opening up markets across the European Economic Area (see Box 2.A).

**2.7** Derivatives exchanges have not been immune to these changes either, and major changes have also been seen, and are continuing to emerge, in the provision of clearing services not only for exchange-traded instruments, but also increasingly for OTC instruments. The ability for clearing houses to accommodate these demands, by having agreements for applying surplus margin for a particular member of one clearing house to its deficit on another, without sacrificing the clearing houses' core ability to manage risk, is known as cross-central counterparty (CCP) margin off-set. Cross-margining agreements between CCPs have been given specific protections in the event of the default of a CCP member, through the Financial Markets and Insolvency Regulations 2009 that make amendments to Part 7 of the Companies Act 1989.

**2.8** Increased choice and interoperability in clearing and settlement are to be welcomed. The competition and innovation that come with them have positive impacts on the efficiency of the financial services sector and also underpin London's position within the European time zone as offering access to the widest range of services on exchanges, at clearing houses and in investment firms.

**2.9** The complexity of trading systems and the interdependence of market participants in meeting their contractual obligations on any trade has meant that markets have set out rules or arrangements to govern how defaults by participants should be treated. These are designed both to secure the continued smooth operation of any market and to provide certainty to counterparties. Indeed, insolvency laws have their origin in such market disciplines. Such default arrangements are not the sole concern of a few market participants; they promote stability and improve efficiency in global financial markets.

**2.10** Historically, the default arrangements in the UK have been designed around the operation of the recognised investment exchanges and recognised clearing houses involved in market contracts, and while these differ in detail, they provide a rule-based framework applying to all trades they cover. The core rules, known as default rules, apply in priority to general insolvency law, and consequently override the often restrictive and retrospective impacts that would otherwise be caused by the onset of insolvency by a participant. In contrast, unless submitted for clearing by a clearing house, the treatment of defaults in relation to an OTC trade is primarily a matter to be determined by the terms agreed between the parties and is subject to general insolvency law.

**2.11** This variety of routes by which a trade may be executed, possibly cleared and ultimately settled, means that in practice there is distinct possibility that within a large transaction, in order to secure best execution, different tranches may be executed on an exchange, on an MTF, and OTC against an investment bank's balance sheet. Even a decade ago the vast majority of equity trades in a default would have been resolved under the default rules of the London Stock Exchange, both as regards proprietary and agency business. Recent events have illustrated that a series of trades (or even a single transaction) between the same counterparties can be subject to very different default arrangements.

**2.12** The Government has supported the growth of diversity and choice in trading, clearing and settlement that has developed over the last decade, and notes that this serves as a core strength of the UK market. This chapter sets out a number of core principles for addressing some of the complexities that come with this, as set out in Paragraph 2.20.

### **Box 2.A: The post-MiFID market, promoting choice and efficiency in trading**

In introducing greater competition in the trading of financial instruments, but particularly equities, across the EU, the EC Market in Financial Instruments Directive (MiFID) established or strengthened a variety of market-facing regulations, including:

**Ending concentration** – the so-called concentration rule present in earlier European legislation which permitted national laws to require that all trades should occur on the local stock exchange has been abolished. It would be unlawful under European law to require all UK listed shares to be traded, for example, only on the London Stock Exchange. Additionally exchanges can no longer require trade reporting by their members of trades not executed through the exchange;

**Recognising regulated markets and MTFs** – MiFID recognises the right of regulated markets and MTFs to provide services across, or being accessed from, anywhere in the EU without local permissions or discrimination; and

Other rules **harmonise technical requirements** such as pre- and post-trade transparency.

In addition, the EC Prospectus Directive provides that once a security is admitted to a regulated market, other regulated markets can only admit it to trading after 18 months and upon the issue of a prospectus. MiFID also limits the ability of a national supervisor to restrict clearing houses from other countries providing clearing in relation to regulated markets and MTFs domiciled in their territory.

It is now possible therefore to trade a UK listed stock on a UK regulated market, on a UK authorised MTF, on MTFs authorised elsewhere in Europe and through investment firms from London and elsewhere. Post-trade processing may or may not involve a central counterparty, which may not be UK supervised if it does not operate in the UK, and ultimately transfer of interests in UK incorporated companies will be registered via CREST.

The Government welcomes the increased choice in trading provided for by the MiFID regime.

## **Building on the existing framework**

**2.13** The failure of LBIE highlighted the complexity of issues around the treatment of open positions when a broker goes into default. The reconciliation exercise involved in dealing with these positions has been substantial, and has left many counterparties lacking certainty with regard to their outstanding exposures and positions.

**2.14** The Government recognises the need to address these issues as promptly and effectively as possible, and has been working with the Advisory Panel, and the working group established under the Panel, to identify key next steps.

**2.15** It should be noted that the Financial Services Authority (FSA) is considering a number of related issues with regard to trading, clearing and settlement under its objective of strengthening market infrastructure, as laid out in Discussion Paper DP 09/2, published alongside the Turner Review. The details are laid out in Box 2B below. The Government is working closely with the FSA, as well as seeking input from the Advisory Panel, to determine the regulatory responses that may be appropriate, alongside other work on possible market and statutory approaches.

### Box 2.B: The Turner Review, FSA DP 09/2: Strengthening market infrastructure

The Turner Review was published on 18 March 2009. It takes an in-depth look at the causes of the financial crisis and recommends steps that the international community needs to take to enhance regulatory standards, supervisory approaches and international cooperation and coordination.

The FSA Discussion Paper DP 09/2, which accompanies the Turner Review, gives further background to those steps and sets out the FSA's initial thinking on how they can be translated into practical policy proposals. A discussion on strengthening market infrastructure responds to concerns which have been expressed about certain aspects of the workings of the market and its regulatory regime. In order for robust and effective market infrastructure to support trading and reduce systemic risk, it deals in particular with the following matters:

- FSA support for measures to strengthen the resilience of OTC markets.
- a review of the arrangements for client protection at clearing houses and
- a review of the handling of defaults by participants in clearing and settlement systems and as parties to OTC transactions.

The period for responses to FSA Discussion Paper DP 09/2 closes on 18 June 2009.

## Objectives

**2.16** In accordance with the general objectives laid out in Chapter 1, the Government is committed to arriving at policy solutions with regard to trading, clearing and settlement issues that have the effect of:

- **protecting the diversity and choice** of trading, clearing and settlement methods for market participants;
- **ensuring clarity**, and building an environment in which the reasonable expectations of market participants with regard to trading, clearing and settlement are consistently matched with outcomes;
- ensuring that **clear and flexible contractual arrangements** can be applied consistently in a manner which secures legal certainty with regard to trading, clearing and settlement; and
- developing appropriate market and regulatory **responses to the technical challenges** surrounding uncertainty with regard to the trading, clearing and settlement of trades not executed on recognised exchanges in the event of insolvency proceedings.

**2.17** This chapter sets out the Government's initial thinking on the steps that may need to be taken in working towards each of these objectives. Each of the objectives is addressed in turn, with additional sub-headings where necessary for greater clarity.

### Protecting diversity and choice

**2.18** This section addresses the first objective, protecting the diversity and choice of trading, clearing and settlement methods for market participants.

**2.19** The Government believes that the diversity of choice currently available to market participants in trading, clearing and settlement following the implementation of MiFID, and other recent developments, must be protected. Furthermore, it is vital to ensure that flexible solutions are established that can accommodate market developments over time. Whilst it is important that the particular problems highlighted by the Lehman Brothers' case are considered and addressed where possible; there may be different issues, not revealed by the LBIE administration that need to be taken into account. It is important that any steps be carefully considered with regard to "future-proofing" the existing regime.

**2.20** In protecting choice for the future, the Government, and the Advisory Panel, have in mind a number of principles and approaches with particular regard to:

- a greater need, both nationally and globally, for transparency of trading, clearing and settlement in financial instruments, and for regulators to be concerned with orderliness in market infrastructure;
- increased use of clearing, and participation of clearing houses in markets for a range of instruments, particularly OTC;
- increased pressure on clearing and settlement competition in the EU and the need to secure interoperability and address contagion risks;
- regulatory requirements for segregated client accounts for trading and settlement;
- more focus on collateral management and counterparty risk; and
- greater consolidation, takeovers and cessations among MTFs.

**Question 1:** Are there any other principles that you believe the Government should consider in addressing its first objective of protecting the diversity and choice of trading, clearing and settlement methods for market participants?

## Ensuring clarity

**2.21** The second objective is to ensure clarity, and build an environment in which the reasonable expectations of market participants with regard to trading, clearing and settlement are consistently matched with outcomes. Possible ways of meeting this objective are set out in the following areas of discussion:

- addressing misconceptions;
- determining the effectiveness of the existing regime; and
- meeting expectations.

## Addressing misconceptions

**2.22** The Government is of the view that a mismatch exists between expectation and experience in relation to trading, clearing and settlement issues, which has the potential to damage confidence in the financial markets. Many of these issues may be addressed through this paper and any resulting further work. However, there are a number of specific misconceptions that are particularly prevalent.

**2.23** Trades (the contractual agreement to buy or sell) must be distinguished from related settlement instructions (a method for facilitating performance of that contract through delivery and payment) entered into a settlement system such as the CREST system. Suspension or deletion of a settlement instruction (which may relate to one or more trades) does not necessarily have an effect on the underlying outstanding contractual obligations.

**2.24** Exchange trades (and those OTC trades involving CCPs) will normally be subject to the default rules of the relevant trading venue or the relevant clearing house. These default rules may close out (cancel and replace with a net cash obligation) all such trades in the event of the default of one counterparty. In these circumstances, related settlement instructions should also not settle, as to do so would contradict the outcome achieved by the antecedent default rules and thereby cause considerable market disruption. The operation of recognised investment exchange and clearing house default rules are protected under Part 7 of the Companies Act 1989, as amended. The systemic impact of a participant insolvency is thereby lower.

**2.25** In contrast, OTC (cash equity) trades not involving CCPs have no applicable default rules and while bilateral contracts may have a variety of contract terms, they may not currently contain terms adequately dealing with default. There is therefore uncertainty in relation to the status of such contracts following a counterparty's default.

**2.26** Settlement instructions in the CREST system become 'irrevocable' when counterparties match instructions, and are incapable of being unilaterally cancelled by one party or an insolvency officeholder. Settlement instructions, from the time they enter the CREST system, are protected from the adverse impact of insolvency related provisions under the Settlement Finality Directive (SFD), as implemented in the UK by the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the Settlement Finality Regulations). They may proceed to settlement safe from challenge. However, such instructions are not guaranteed to settle, as a number of issues may prevent this. These include availability of securities and cash (as settlement banks do not provide committed credit lines), as well as disablement of an insolvent counterparty.

**2.27** Euroclear UK & Ireland Limited (EUI), as operator of the CREST system, is required under the Settlement Finality Regulations to have in place default arrangements (to be distinguished from default rules of exchanges and CCPs noted above). These arrangements are designed to minimise the impact on the CREST system of the default of a participant in that system. EUI does not have the ability to make default rules to interfere in the underlying trades (because it plays no part in such trades and may have no relationship with the trading counterparties). Under the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001, EUI is not required to have Part 7 default rules as it is not a party to (and has no role in) market contracts.

**2.28** The Government welcomes the new guidance to CREST Rule 13 provided by EUI (see Box 2.C). However, it recognises that such guidance can only form part of a wider market response to help resolve uncertainty.

**2.29** The Government will consider whether there is sufficient transparency about how the default terms and arrangements will operate for open equity trades. It recognises that this is critical to ensure that there is clarity around expected and acceptable standards of market conduct.

### **Box 2.C: Guidance to CREST Rule 13<sup>1</sup>**

CREST Rule 13 sets out Euroclear UK and Ireland (EUI)'s settlement finality related rules and requirements, including its default arrangements for settlement under the CREST system.

EUI has now published additional guidance to CREST Rule 13 to explain how it responds in the event of a CREST participant default. This guidance clarifies how EUI would exercise its existing powers and reflects steps taken in the LBIE context and other default situations.

The guidance clarifies the fact that, on insolvency, defaulting participants will have their CREST system participation disabled, suspending settlement in relation to that counterparty. Where that suspension of settlement will be permanent (for example if 'on exchange' trades have been closed out and related settlement instructions must be prevented from settling), EUI will promptly notify the market. Alternatively, where certain specified criteria are met within five days, the participant may be subsequently re-enabled and settlement recommenced. Where settlement has been permanently suspended, EUI may instruct participants to bilaterally delete any remaining unsettled settlement instructions.

## **Determining the effectiveness of the existing regime**

**2.30** There is some evidence to suggest that brokers and their clients bring different understandings of the operation of the existing regime with regard to events of default. The Government is seeking to develop an understanding of the expectations of both investors and brokers with regard to their contractual relationships. On the basis of these revealed expectations the Government, with advice from the Advisory Panel, will seek to determine how effective the existing regime has been in meeting them.

### **Meeting expectations**

**2.31** The Government is of the view that there is a need to ensure that investors are put in a position to allow a realistic assessment of the level and nature of the risk they are taking when they transact with an investment bank, including the downside they face should that investment bank fail.

**2.32** The Advisory Panel has noted that investors do not wish for their risk profile or their trading activity to be adversely impacted as a result of the choice of exchange and clearing processes applied by their broker. It is apparent that some investors currently have little understanding of the execution and clearing and settlement choices being made by brokers on their behalf. Investors consequently do not understand the variable cost and risk exposures that such choices mean for them.

**2.33** Regulatory requirements regarding best execution do not address these issues and there is currently a considerable lack of transparency. It may also be the case that investors could exert little influence over the choice of clearing and settlement providers even if full transparency were to exist.

**2.34** It is not the role of Government to seek to materially alter an investor's ability to select the level and nature of risk they undertake. However, investors may lack understanding that such choices exist. Any reforms should aim to put in place a framework encompassing market

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<sup>1</sup> [www.euroclear.com](http://www.euroclear.com)

practice, regulatory changes and legislative provisions that make it possible for an investor to more accurately quantify and manage the risk they assume when dealing with an investment bank.

**Question 2:** How do you think the Government can best address the second objective, that of ensuring clarity, and building an environment in which the reasonable expectations of market participants with regard to trading, clearing and settlement are consistently matched with outcomes?

## Clear and flexible contractual arrangements

**2.35** The third objective in this chapter is ensuring that clear and flexible contractual arrangements can be applied consistently in a manner that secures legal certainty with regard to trading, clearing and settlement. This section contains a sub-section on addressing difficulties in contractual negotiations.

**2.36** It is highly desirable to establish certainty for market participants as to whether any given trade with an insolvent investment firm has been closed out or otherwise cancelled, or whether it is intended that it will settle. This is critical in enabling investors (e.g. funds) to manage their own risk in the event of the default of their broker.

**2.37** Currently, in many transactions there are no formal written contracts, or there are contracts (for cash settled off exchange transactions) that do not stipulate default arrangements that cover the event of counterparty default. They establish conditions with regard to the nature of a trade to be conducted. Furthermore, such contracts may not contain arrangements with regard to the insolvency of either of the contracting parties.

**2.38** The Government believes that there is a case for the establishment of standard default rules that provide contractual certainty for what will occur in the event of broker default for transactions that are not already covered by exchange default rules or other default provisions. There are two principle avenues of approach that could be pursued:

- a market-led solution. The market is working on a draft protocol. The Government, and the Panel, support this approach and would welcome an extension of the protocol to a wider range of market participants if this proves possible. A market approach would have the advantage of flexibility, and would be fully bedded in with market expectations; and
- a statutory solution. The advantage of statutory default rules is that they can be made to apply on a mandatory basis and can therefore be applied on a universal basis, avoiding the possibility of a two-tier system.

**2.39** Contractual certainty may enable greater certainty at clearing and settlement levels. However, the effectiveness of any market protocol to implement default provisions will need to be considered further, for example to ensure its wide adoption, to consider what statutory protections may be required and how contractual arrangements are communicated to market infrastructure.

**Question 3:** The Government would welcome views on whether a market-led or statutory approach to ensuring contractual certainty is appropriate. In particular the Government

would welcome views on, if market participants were to develop a protocol for determining the outcome of the contractual position of the underlying parties to the trade, what might need to be done under Part 7 of the Companies Act 1989 or otherwise to ensure the protocol is effective?

**2.40** The Government notes that a sub-group of the Financial Markets Law Committee (FMLC) is considering areas of legal uncertainty that arise in cases similar to the Lehman Brothers' default, as laid out in Box 2.D.

#### **Box 2.D: Financial Markets Law Committee<sup>2</sup> (FMLC)**

An FMLC working group has been established to consider contractual issues regarding over the counter (OTC) trades in cases such as Lehman Brothers. The temporary suspension of certain unsettled OTC trades in the CREST system following Lehman Brothers International (Europe)'s (LBIE) entry into administration highlighted an area of legal uncertainty, which is being addressed by the Group.

The working group is considering whether there are appropriate non-legislative changes that could be implemented or whether a legislative solution is desirable. The Group is also considering related questions, including whether the Settlement Finality Directive (SFD) requires that national settlement systems deal in any particular way with trades involving insolvent participants; or whether the SFD otherwise provides grounds for Member States to choose to impose default rules on settlement systems, such that the rules can be implemented via secondary legislation under section 2(2) of the European Communities Act. Finally, the Group is conducting a contractual analysis of OTC cash equity trades and the question of how any contractual termination provisions might be notified to, relied upon by, and implemented in, the CREST system.

The FMLC working group is likely to conclude that, whilst EUI guidance supplementing CREST Rule 13 is a notable contribution to the efforts to afford greater predictability in this area, the FMLC considers that the guidance is, without further clarification, unlikely to provide sufficient legal certainty. The FMLC is also likely to note that a market protocol will help clarify the situation but that there may be difficulty in EUI implementing a termination provision to which it is not a party by imposing a match-delete instruction on the parties. The FMLC is currently considering the suggestion that an amendment should be made to the Insolvency Rules 1986 to require an administrator to delete transfer orders pertaining to any outstanding settlement instructions in the event of the administration of a large financial institution. The FMLC working group will report in due course.

### **Addressing difficulties in contractual negotiations**

**2.41** Some members of the Advisory Panel take the view that there are issues with regard to the equality of bargaining power when contracts are created that have presented barriers to the establishment of balanced contracts that provide for certainty in the event of broker default. There may also be scope for investors to play a more active role in improving their awareness of

<sup>2</sup> [www.fmlc.org](http://www.fmlc.org)

the contractual terms to which they agree. The Government will continue to consider this matter, and would welcome further views.

**Question 4:** How might the Government best address the third objective, ensuring that clear and flexible contractual arrangements can be applied consistently in a manner which secures legal certainty with regard to trading, clearing and settlement?

## Responding to technical challenges

**2.42** The final objective of this chapter is developing appropriate market and regulatory responses to the technical challenges surrounding uncertainty with regard to the trading, clearing and settlement of trades not executed on recognised exchanges in the event of insolvency proceedings.

**2.43** The Government will consider whether further operational changes are necessary to the functioning of trading, clearing and settlement systems, and whether market, regulatory or legislative responses are appropriate. Some of those matters have been considered in FSA Discussion Paper DP 09/2, as described in Box 2.B above, and so the discussion in this paper is correspondingly brief on those matters.

**2.44** The issues involved in addressing this objective are discussed in relation to the following areas:

- trading;
- clearing – central counterparties;
- clearing – margin transfers;
- settlement; and
- derivatives positions.

### Trading

**2.45** The Government notes that operational problems with regard to trading processes have been identified that were highlighted in the Lehman Brothers' default. They primarily relate to the correct identification and classification of the venue on which a trade was implemented. They may occur, to some extent, as a result of changes arising from the implementation of MiFID.

**2.46** The Government seeks to strengthen firms' systems and controls to prevent any future recurrence of this problem, and will be considering what steps may be necessary, in collaboration with the Advisory Panel.

### Clearing – central counterparties

**2.47** CCPs interpose themselves between the buy and sell sides of each trade that is 'cleared' and act to guarantee the performance of the trade by becoming the counterparty to the original parties to the trade.

**2.48** The FSA is reviewing the arrangements for the holding of both client positions and margins at the clearing house level. This review has been prompted particularly by the Lehman Brothers'

default where client positions were held in a house account (which generally allows some economising on margin, as positions can be netted across client and house business). That situation has raised questions as to the level of understanding by clients of the effects of account segregation and the appropriateness of current clearing account arrangements.

**2.49** In its recent Discussion Paper DP 09/2 The FSA has identified in a number of potential options for clearing account structures at the clearing house level as follows:

- maintenance of the status quo, although with a requirement for greater transparency and disclosure of the segregation arrangements to market participants;
- the introduction of an explicit requirement that clearing houses offer facilities for their members to segregate client business (effectively formalising current standard market practice in the UK, but giving the FSA greater traction over overseas clearing houses that wish to provide services in the UK);
- the introduction of a requirement that all client business be held on a segregated basis; and
- the introduction of a requirement that client business must be held in a client-specific (i.e. one account per client) 'designated' account and/or that all client business must be margined on a gross basis.

**2.50** The FSA is also analysing the current default arrangements of UK recognised clearing houses and recognised exchanges. The objective of this review is to study mandatory and optional actions that are available to the clearing house or exchange both before and after the declaration of a default, and to analyse if elements of the UK arrangements could cause difficulties.

**2.51** The Government welcomes the steps that the FSA is taking in this area, and will work with them to support robust amendments to the arrangements for CCPs.

## **Clearing - margin transfers**

**2.52** The rules of clearing houses generally allow the positions of defaulting clearing members to be moved to other clearing members or dealt with otherwise. By contrast, moving margin that has been provided for those positions to another clearing member requires the consent of the defaulting clearing member or its insolvency official. So the ability of insolvency officials to give that consent would be relevant.

**2.53** The Government notes that there were a range of views represented on the Advisory Panel with regard to any requirement that resolution of positions left open in the event of an insolvency through the transfer of such positions to a third-party should also enable the transfer of customer margin alongside the associated positions. The Government will consider further, with continued input from the Panel.

## **Settlement**

**2.54** In addition to the contractual issues that may arise, and which have been discussed above, the Government believes that there may be a case for addressing settlement procedures, how they interact with insolvency of a participant, and how insolvency practitioners may engage with them.

**2.55** The Government will consider whether there is a case to:

- make changes to Part 7 of the Companies Act 1989 in order to clarify procedures with regard to settlement instructions in the event of an insolvency;
- make changes to the regulations governing CREST's operation to delete all affected settlement instructions upon default to facilitate trading out of risk;
- introduce standardised default rules and to consider the width of existing rules; or
- make changes to the duties and powers of administrators and settlement banks, and the immunities attaching to them.

**2.56** The Government notes that market participants will naturally strive for certainty as to how their transactions will be settled - both generally and in circumstances where a participant becomes insolvent. In order to accomplish this administrators or other insolvency officials should liaise with EUI at the earliest possible stage following their appointment to clarify how unsettled instructions in the CREST system will be handled. Insolvency officials would also need to work closely with the relevant settlement banks.

**2.57** In addition, the Government notes that the rules of the exchanges, clearing houses or settlement systems set out in what circumstances transactions are covered by their rules. It is incumbent upon market participants to understand the scope of those rules and the extent to which they have insolvency protection afforded by Part 7 of the Companies Act 1989 and the SFD.

**2.58** The Government notes that EUI is not able to delete settlement instructions centrally as the regulations under which it operates require deletions only to occur following electronic instruction from participants. Where trades have been closed out or settlement has been permanently suspended, participants should therefore bilaterally input deletion instructions.

**2.59** The Advisory Panel has discussed a non-discretionary permanent disablement of EUI settlement (and removal of settlement instructions through a mechanism to be determined) in relation to insolvent entities, even though this may not be in the best interests of the insolvent estate or market participants in particular circumstances. In particular, this immediate permanent suspension or deletion may prejudice the interests of the insolvency officeholder in performing their role.

**2.60** A lack of default rules for the related OTC trades may be relevant to the uncertainty which has arisen as to the status of such trades following counterparty default and in dealing with the related settlement instructions. If a legal framework were in place for dealing with default in relation to OTC trades, this could provide a basis for dealing with related settlement instructions.

**2.61** The Government notes that the FSA discussion paper, DP 09/2, describes how consideration continues to be given as to whether the current arrangements for dealing with the default of a market participant to OTC transactions can be improved and sets out possibilities for changes. They could range from fixing particular problems to a more broadly-based approach, including the introduction of a new OTC default regime, perhaps with the extension of protection similar to Part 7 of the Companies Act 1989 to default mechanics that are or may be used in the market. Any such changes could include market-led initiatives, changes in how settlement systems operate, or legislative, regulatory or other ones.

## Derivatives positions

**2.62** The Government, in consultation with the Advisory Panel, will also consider particular issues related to derivatives transactions which have been highlighted by the LBIE default. In particular it may be helpful to consider issues around the ways in which Master Agreements operate in the event of broker default, and the way in which valuations of derivative positions occur.

**Question 5:** How might the Government best address the fourth objective, developing appropriate market and regulatory responses to the technical challenges surrounding uncertainty with regard to the trading, clearing and settlement of trades not executed on recognised exchanges in the event of insolvency proceedings?

**Question 6:** Do you have any other views on the issues of trading, clearing and settlement that you feel are important for the Government to consider?



# 3

## Client assets and monies

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**3.1** Prior to the failure of Lehman Brothers, the impacts on client assets and monies of insolvency proceedings in respect of a major investment bank had not been fully factored into market expectations, either in the UK or in other jurisdictions. It is now clear that such impacts can be significant, and there is a need to ensure that where clients have proprietary rights in assets or monies held on their behalf, such assets and monies will be returned promptly following insolvency.

**3.2** This chapter therefore focuses on issues around the return of client assets and monies in the event of the commencement of insolvency proceedings. In particular it considers cases where effective segregation has not occurred, or where complex liens or set-off arrangements exist or rehypothecation has occurred. This chapter explores existing arrangements, the extent of potential problems, and the scope for addressing them through legislative, regulatory or market solutions.

**3.3** Any such solutions will need to balance the potential impact from both a client's and a broker's perspective, take into account any adverse consequences on other areas of the market, and maintain London's competitiveness as a financial centre. Any proposed regulatory changes will be for the Financial Services Authority (FSA) to consider and if necessary take forward by way of consultation.

**3.4** The key concern for the Government is to ensure that the legitimate and reasonable expectations of clients for the protection and return of assets are met in a manner that allows for the maintenance of a flexible and competitive market for prime brokerage in the UK. The Government notes that the FSA is to bring forward a consultation paper on possible changes to its rules on client assets later this year, taking into account the work arising from this and subsequent consultation papers.

### Background

**3.5** Client assets, as referred to in this paper, are the financial instruments that belong to the clients of an investment firm and are held on their behalf by the firm in the course of its investment business. Similarly, client money is money that a firm holds for or on behalf of a client in the course of its investment business. These are assets and money in which clients have proprietary interests and which are distinct from the assets and money of the firm. Accordingly, there are expectations that the failure of the firm should not substantially impact the return of such assets and money to clients of the firm because they fall outside the general estate of the firm.

**3.6** The protection of clients' interests in client assets and client money is a cornerstone of investor protection in the UK, with such interests protected under both the regulatory regime and under English law generally. The expectation of clients that their proprietary rights will be appropriately protected is an important part of the UK's attractiveness as an international financial centre.

**3.7** Clients are right to have such expectations of the UK regime. Notwithstanding this however, the failure of Lehman Brothers International (Europe) (LBIE) has highlighted a number of

practical difficulties with regard to the ability of clients to gain access to their assets and monies promptly and transparently.

**3.8** The failure of LBIE has highlighted a number of issues that can affect the speed with which client assets and client money can be returned upon the insolvency of an investment firm, including, but not limited to, difficulties in:

- reconciling books and records in large, and highly complex, institutions;
- establishing clients' net claims where there are margin lending arrangements in place;
- establishing the extent of re-hypothecation of client assets; and
- securing the return of assets and money from custodians and sub-custodians globally.

**3.9** The fact that there have been practical difficulties in this area is perhaps unsurprising. As indicated in Paragraph 3.1, the practical implications of returning client assets and monies in the event of the failure of a firm with such a complex arrangement of client assets and monies as Lehman Brothers were not fully considered in any jurisdiction.

**3.10** Notwithstanding these difficulties, which have also been experienced in other jurisdictions, the Government believes that the protection of client assets and monies in the UK remains robust. In particular the UK, unlike some other jurisdictions, fully protects the assets and monies of overseas clients by making no distinctions between domestic and overseas parties. By contrast, the focus on domestic positions in some other jurisdictions leaves open the possibility that international clients may not have had their interests fully protected, unlike in the UK.

**3.11** The Government also notes that a number of the criticisms that have been made of the existing UK regime with regard to client assets and monies are based on misconceptions as to how it operates in practice. It is important that clients and providers of investment banking services themselves have clear and reasonable expectations as to the existing protections that are in place. This chapter therefore sets out in some detail how the UK regime currently operates.

**3.12** That said, the Government recognises that there is a need to address the problems highlighted by the LBIE failure as quickly and effectively as possible. The chapter therefore also explores whether any changes to market and regulatory practice, or legislative reforms are appropriate to strengthen investor protection in the UK.

## Objectives

**3.13** In accordance with the general principles laid out in Chapter 1, the Government is considering possible legislative, regulatory and market reforms which have the effect of:

- **ensuring clarity** with regard to the ways in which client assets and monies are treated on insolvency, **and addressing misconceptions** as to the protections in place;
- **improving transparency** by facilitating the identification and legal categorisation of client assets and monies following the commencement of insolvency proceedings and the legal categorisation of a client's rights in respect of those assets and monies;
- **improving the speed of access** of investors to their assets and monies which are held on trust; and
- **ensuring that sufficient flexibility is maintained** in order to enable investors and brokers to arrive at mutually acceptable outcomes, and to ensure that any new regime is both 'future-proof' and has no substantial negative impacts.

**3.14** In order to achieve these objectives, the Government recognises that any solutions will need to address the position of both encumbered and unencumbered assets. An encumbered

asset is property owned by one party, but subject to the legal claims of another party, including under rights of set-off. Unencumbered assets can generally be identified and distributed more quickly than encumbered assets.

**3.15** In working towards these objectives, the Government will also consider cases where client assets are held with third party custodians and where they are subject to rights of use by brokers.

**3.16** Finally, in exploring possible solutions, the Government will have regard to whether they would be commercially feasible and to the benefits that they could be expected to provide in the light of the costs and burdens that they would entail.

## Ensuring clarity and addressing misconceptions

**3.17** The Government is aware that there has been market commentary with respect to the operation of client asset and money protections following the LBIE failure. It is not for the Government to comment on the specific details of that administration, although, as indicated in Chapter 1, there is significant evidence that major progress is being made, including with respect to the return of client assets and monies.

**3.18** At present, the Government believes that recent concerns reflect difficulties with regard to the practical implementation of the UK regime for client assets and monies, rather than underlying problems with the general protections themselves.

**3.19** There is however a more general issue around clarification for market participants as to the levels and nature of protection they can expect, and how these will operate in the event of a major insolvency.

**3.20** The Government believes that there are two main avenues for ensuring greater clarity around the protection of client assets in the event of an insolvency. These are described in Paragraphs 3.21 to 3.39 and include;

- a **market response**, based on the establishment of clearer contractual terms, and detailed scrutiny of contracts; and
- a regulatory response, with greater **clarity with regard to the existing regime** provided by the Government and the FSA.

These approaches are laid out in detail below.

## Market responses

**3.21** Prior to the failure of Lehman Brothers, it may have been the case that clients did not, in all cases, fully scrutinise every aspect of their prime brokerage agreements due to the general assumption that a firm of such size would be 'too big to fail'. In some cases therefore, clients may not have considered the implications of providing rights of use, for example, in terms of their ability to access assets following default by their broker. It may also have been the case that brokers themselves were able to set advantageous contractual terms. The Advisory Panel has considered a range of views around this issue.

**3.22** The Government notes that there is a significant role for a market response in this area, and this response may already be occurring as contractual engagements come under more sustained scrutiny to provide for robust outcomes in the event of a failure of either a client or their broker.

**3.23** The Government believes that such market responses can be supported through renewed work by the Government, and the FSA, to explain the current regime, as laid out below.

## Clarifying existing practice

**3.24** This section of the chapter describes the existing UK regime, and is designed to address existing misconceptions as to how client asset and money protections operate in practice.

**3.25** The Government considers that in order to consider whether any reforms are appropriate to strengthen the protection of clients' interests in client assets and client money, it is necessary first to understand the protection that is currently afforded in the UK under English law and under the UK regulatory regime.

**3.26** Effective asset and money segregation is the basis of client asset and client money protection in the UK. Under English law it is generally accepted that a client has a proprietary interest in any client assets or monies that have been properly segregated from the assets or monies of the firm and in respect of which assets no rights of use, or rehypothecation, have been exercised.

**3.27** In the case of assets or monies held through a global client account, the consensus view under English law is that each client has a co-ownership interest in the pooled assets or monies in the percentage that their claim bears to the aggregate pool.

**3.28** It is also generally accepted under English law that, where an investment firm does not comply with its obligations to segregate client assets or monies, the client will have no proprietary interest in such assets or monies (unless a tracing case can be established).<sup>1</sup>

**3.29** Furthermore, where the client has granted the firm a right of use over certain assets and such right of use has been exercised, the client will have no proprietary interest in respect of assets that are no longer in the client account.

**3.30** In other words, the extent of any proprietary interest that a client can legitimately claim over assets and money depends on the factual scenario and how the client assets and monies have been dealt with. Some of these scenarios and their legal effect are summarised briefly in the following table.

**Table 3.A: Types of propriety interest**

Scenario	Legal Effect
No rights of rehypothecation. Obligation to segregate client assets in individual client accounts.	Client will have proprietary interest over individual account.
No rights of rehypothecation. Obligation to segregate client assets in a global client account.	Client likely to have co-ownership interest (as tenant in common) in global client account.
No rights of rehypothecation. Obligation to segregate client assets but no such segregation takes place.	Client unlikely to be able to trace the assets into investment firm's general securities account.
Obligation to segregate client assets, which has been complied with. Rights of rehypothecation exist but have not yet been exercised.	The existence of rights of rehypothecation <i>per se</i> are not fatal to client's trust interest, but where investment firm has desegregated the securities (by removing them from the client account) client unlikely to be able to trace into investment firm's general account.

<sup>1</sup> This was confirmed recently by the High Court in *Re Global Trader Europe Limited (in Liquidation)*, 24 March 2009.

Obligation to segregate client assets, which has been complied with. Rights of rehypothecation exist and have been exercised but equivalent securities have been “returned” to the client account.	Client’s co-ownership interest in the client account should extend in proportion to the securities “returned”.
Obligation to segregate client assets, which has been complied with. Rights of rehypothecation exist and have been exercised; equivalent securities have not been returned to the client account.	Client will have no proprietary interest in securities.

Source: Allen & Overy LLP

**3.31** Client asset and money protection is also afforded under the UK regulatory regime. The Financial Services and Markets Act 2000 (FSMA) empowers the FSA to make rules which apply to authorised persons, including rules relating to client assets and money and rules which create a statutory trust designed to protect clients' money. Such rules are contained in the FSA Client Assets Sourcebook (CASS).

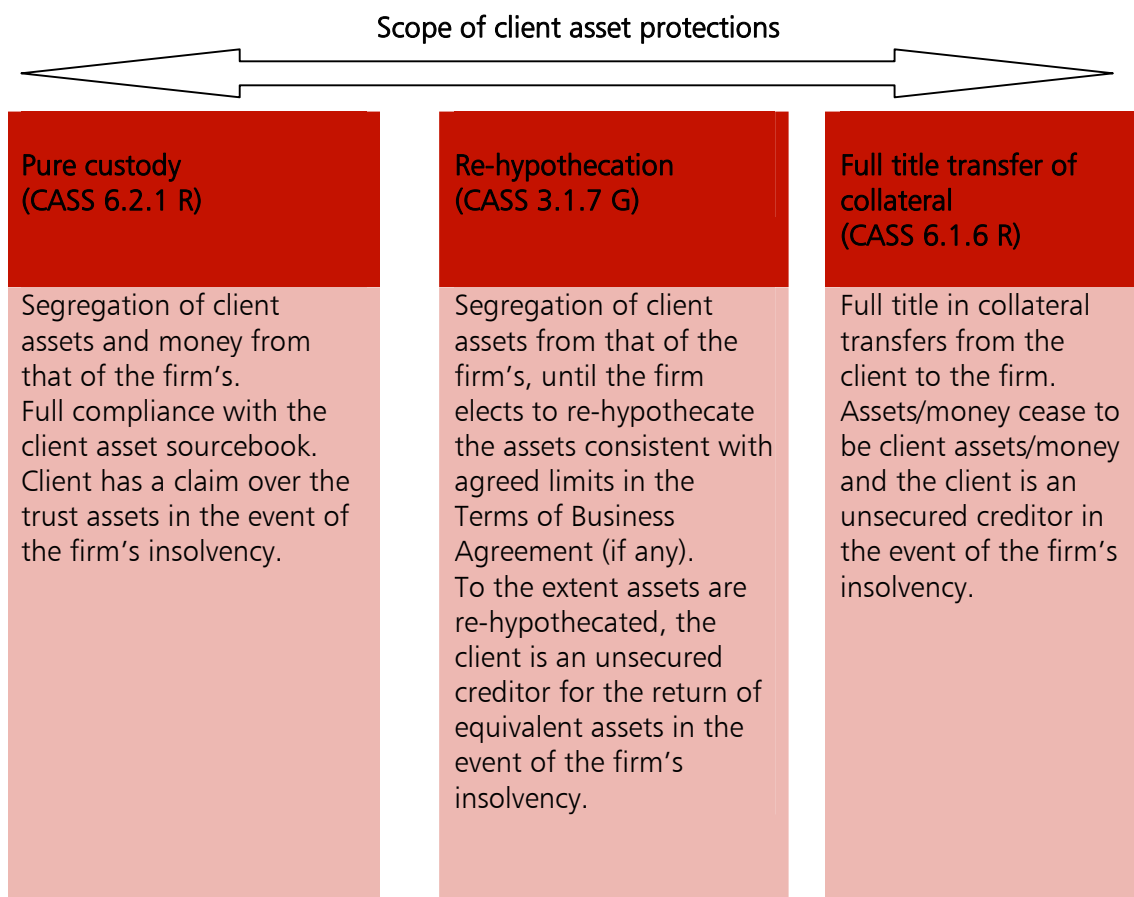
**3.32** CASS requires the segregation of client money and the operation of client money trust accounts. It also creates a statutory trust over client money that is effectively segregated.

**3.33** Although FSMA does not specifically empower the FSA to make rules creating a statutory trust designed to protect clients’ assets, CASS imposes requirements on firms to ensure that adequate arrangements are in place to safeguard clients’ interests in client assets. These arrangements will generally involve firms holding client assets subject to trusts or other proprietary entitlement in favour of the clients.

**3.34** A clear advantage of the CASS regime is that it allows flexibility between firms and their clients to determine the appropriate level of protection that should apply in the context of their arrangements, taking into account cost considerations. For example, it is possible under CASS for the parties to choose to apply the full extent of the client asset or client money protection in the context of their arrangements. Alternatively, clients can agree to opt out of client asset or client money protection altogether by transferring full ownership of assets or money to the firm. A client may agree to do this, for example, for the purpose of securing its present, future, actual or contingent obligations. It is also possible for a client to choose to have its assets held in segregated custody but to grant the firm a right of use of the assets. Such right of use (often referred to as a right of rehypothecation) can be limited or unlimited, subject to agreement between the parties. It is used, for example, to finance margin lending to clients.

**3.35** Figure 3.A reflects the spectrum of options available under CASS.

**Figure 3.A: Scope of client asset protections**



**3.36** The FSA's client asset protection regime is one that may result in complexity where the client agrees that the firm may lift assets from custody and use them as security for cash and securities lending undertaken by the firm. Although such arrangements may be complex, the rules and the legal concepts on which they rely do provide a secure basis for the client's assets that remain segregated to be effectively protected.

**3.37** However, complexity increases the risk of practical difficulties arising when identifying and locating specific assets which are held on a segregated basis and when assessing the nature of the legal relationship governing those assets. Such practical difficulties may mean that it will take longer on the insolvency of the firm to bring about a return of the client's assets. However, this does not mean that the client's entitlement to such assets is not legally secure.

**3.38** Although the client asset and client money protections afforded in the UK are legally sound, it is important to explore areas where they could possibly be improved. The Government understands that the FSA will be considering the client assets and client money rules in CASS in the light of recent market events, and plans to publish a consultation paper towards the end of 2009.

**Question 7:** What are your views on how the Government can best address its objective of ensuring clarity with regard to the ways in which client assets and monies are treated on insolvency, and addressing misconceptions as to the protections in place?

**3.39** For the purposes of this paper, the Government has considered certain market, regulatory or legislative measures that could be taken to address some the key difficulties that have arisen

in the context of the LBIE administration. As discussed in Paragraph 3.13, the rest of this chapter will consider issues relating to:

- **transparency** as to rights over client assets
- enhancing the **speed of access** of client assets; and
- **maintaining flexibility** and a balanced regime.

## Improving transparency

**3.40** Facilitating the effective and early identification of client assets, by ensuring that they can be correctly classified quickly, is crucial to ensuring their prompt return, in the event of a firm that holds or directs assets entering insolvency proceedings. Without proper identification and classification it is extremely difficult for administrators to return assets quickly.

**3.41** Proper transparency, that is, fully effective identification and legal classification of client assets is also essential in enabling clients to have an understanding of how the process of insolvency will affect them, and enabling them to have greater clarity as to how their assets and monies will be treated. This is vital for the client, in enabling them to plan their business, fully identify the nature of their assets and liabilities and take action where appropriate. It is also important in providing clarity to the market at large, establishing confidence and protecting financial stability.

**3.42** The Government therefore takes seriously the issue of transparency as to the treatment of client assets and monies following default.

**3.43** There are three aspects to the Government's objective in securing greater transparency around the treatment of client assets and monies, which are explored below. These are:

- **resolving practical issues through better record-keeping and reporting;**
- **providing information around the segregation and rehypothecation of assets;** and
- **establishing legal clarity as to the basis on which assets are held.**

## Resolving practical issues through better record-keeping and reporting

**3.44** In the case of the failure of a major investment bank, where there will be a highly complex set of arrangements with regard to the assets and monies held by the firm, insolvency practitioners may face substantial practical difficulties in identifying both the extent of client assets, and any interests over such assets.

**3.45** The Government considers that a key way to facilitate an insolvency practitioner's job is to ensure better documentation and accuracy of books and records (including reconciliation with sub-custodian books and records) in order to allow them to ascertain more easily the firm's position in relation to client assets and money. Some related proposals are laid out in Chapter 4, but there are a number of steps that the Government considers may need to be taken with regard to record-keeping that pertain to client assets and monies in particular.

**3.46** The Government considers that enhanced record-keeping and reporting could be a market solution, by contractual agreement of the parties or market best practice guidance, or could potentially take the form of prescriptive regulations. The Government is also considering whether additional reporting requirements should be placed on firms providing investment banking services. Any such requirement would be for the FSA to determine, but may involve the need for more regular reporting on a range of additional areas with regard to the ways in which client assets are being held, managed, or directed.

**3.47** Examples of information that could be required to be reported include:

- what assets are being held;
- on what basis;
- where they are held (i.e. by custodians);
- in which jurisdictions;
- what rights of set-off exist over them;
- aggregate value of assets in respect of which a right of use has been exercised and the amount at a Committee on Uniform Securities Identification Procedures (CUSIP) level;
- value of rehypothecated securities compared to segregated custody positions;
- the exposures which are taken into account in determining the net liabilities against which any rehypothecation limit is set;
- net claims; and
- the extent of any liens over assets.

**3.48** In addition, in order to be effective, any records and reports would need to be produced in an accessible format, and subject to frequent reconciliation of the house records with those of clients and custodians.

**3.49** However the Government notes that the establishment of good record-keeping and reporting practices alone may not be sufficient to address all of the practical difficulties emerging with regard to transparency following the failure of a major investment firm. Problems may arise, for example, where books, records or systems are held or operated by, or are dependent on, people or systems in different jurisdictions and over which the UK insolvency practitioner has no control.

**3.50** It should be noted that, while the Government considers that steps in this area would be beneficial, the act of entry into insolvency proceedings inherently complicates the ability of a firm's administrators to manage, update and reconcile information systems. Therefore the potential limitations of this approach should be recognised.

**3.51** Such difficulties may, in some cases, be partially ameliorated by full explanation of the operation of internal systems. Chapter 4 lays out proposals for how any such record-keeping requirements may be embedded in detailed 'business information packs', which could be made available to insolvency practitioners on day one of the firm entering insolvency.

### **Providing information around the segregation and rehypothecation of assets**

**3.52** The Government also considers that there may be a need for investment banks to take further steps to clarify with their clients the manner in which they are segregating and, where appropriate, rehypothecating client assets. Evidence suggests that the market is already taking steps in this area, for example in response to the client demand that they are able to receive information on a daily basis as to how many and what assets have been rehypothecated.

**3.53** The Advisory Panel has also discussed the possibility of enhancing risk warnings in contractual arrangements, emphasising the implications of opt-out of client asset protections, the exercise of the right of use over assets and the full title transfer of assets. The Government, in consultation with the Advisory Panel, will consider the degree to which a firm should ensure, when negotiating with a client, whether the client understands the implications of the exercise of a right of use over assets.

**3.54** The Government believes that greater transparency regarding rehypothecation rights could address possible misconceptions about the implications of the exercise of rights of use and manage clients' expectations regarding their rights over assets that have been rehypothecated. In addition, the Government believes that it may be appropriate for firms to share information with clients on the parameters discussed in Paragraph 3.47.

### **Establishing legal clarity as to the basis on which assets are held**

**3.55** The Government notes that English trust law, under which client assets and monies are held, is well established and, in most cases, clear. The legal position with regard to the holding of client assets and monies is briefly described earlier in this chapter.

**3.56** English law's use of trusts and its capacity to treat intangible rights as proprietary in nature makes it particularly adept at dealing with the custody and transfer of financial assets. Despite some initial perceptions to the contrary, the problems experienced in the Lehman Brother's insolvency do not appear to have any substantial roots in legal uncertainty.

**3.57** That said, many of the legal scenarios that may be generated by the failure of a financial institution are complex and the analysis and resolution of them may prove difficult. The challenges faced by the administrator of a complex investment firm and by its clients in seeking the return of their assets and monies would, hypothetically, be greatly increased if there were to be any uncertainty as to the way in which the law would be applied in identifying these assets and determining the client's rights in them.

**3.58** There may be cases in which legal categorisation is difficult or may benefit from clarification, and the Government will consider these issues, with input from the Advisory Panel.

**Question 8:** What are your views on how the Government can best address its objective of improving transparency by facilitating the identification and legal categorisation of client assets and monies following the commencement of insolvency proceedings and the legal categorisation of a client's rights in respect of those assets and monies?

### **Improving the speed of access**

**3.59** The ability of clients to secure the return of their assets in a timely manner is important, both to the interests of the client, in particular with regard to their being able to meet their own further obligations, and in terms of the general public interest in liquid and stable financial markets. Easier identification and classification of assets, as discussed in the section above, will no doubt play a part in the speed with which they can be returned to clients, but there are a number of other steps that could be considered. This section highlights some of the measures that might be taken to facilitate a speedier return of client assets upon the insolvency of an investment bank.

**3.60** This section covers issues that the Government is considering that may help to improve the speed of access to client assets. Steps under consideration include, but are not limited to:

- possible changes to the **use of third party custodians and affiliates for holding client assets and monies**;
- possible **changes to the way in which client money is segregated**;
- possible changes to **arrangements for set-off and liens**;
- the establishment of **bar dates to crystallise claims**;

- possible changes to the regime around rehypothecation;
- the possible creation of **special officeholders or objectives for reconciling client assets** as a matter of priority; and
- the **establishment of bankruptcy remote vehicles** to establish market-led forms of client asset protection

These issues for consideration are discussed in further detail below.

## **Use of third party custodians and affiliates for holding client assets and monies**

**3.61** Particular difficulties with regard to the return of client assets may exist in cases where they are held with third-party custodians and with affiliates of a group of which a given investment firm is part. In particular, where third-party custodians have liens or security interests over assets held in custody there may be delays associated with the return of such assets while these interests are identified and worked through.

**3.62** The Government does not intend to suggest that the use of such liens is inappropriate in any way, but there may be a case for considering whether restrictions on their use might be appropriate in the context of custody arrangements. Investment banks could, for example, be requested or required by the FSA to ensure that sub-custodians waive any security interest, lien or right of set-off (to the extent permitted by law) over assets held for the benefit of clients as client assets or client money with respect to liabilities owed by the investment firm in a principal capacity. If such an approach were to be pursued firms would need to identify clearly to clients the jurisdictions where this could not be achieved.

**3.63** Clearly any such proposal would need to be carefully considered, and may not prove to be practicable in all circumstances. The Government would welcome views on this, and other options for dealing with the interests which may arise from sub-custodians.

**3.64** Further difficulties may exist, and indeed were highlighted in the LBIE case, with regard to the international group structure of investment banking providers, particularly their use of affiliates to hold client assets and monies. It is highly likely that, should any major investment firm go into default, that default would affect the whole of the group of which it was part, therefore intra-group contagion is likely to present difficulties in accessing assets and monies held with affiliates.

**3.65** It has been suggested that, to reduce the risk of group contagion, restrictions could be placed on the placing of client money and client assets with affiliated undertakings. One suggestion is that the client money rules might be amended to provide:

- that firms are not permitted to place more than a certain limit of client money and client assets with affiliates;
- that firms report on a daily basis the list of banks with which they hold client money and the percentage of the firm's client money lock-up which is held with each bank in order to assist clients in understanding their credit risk;
- for regular reporting in relation to where client assets are held; and
- that firms should have the ability to ring fence different pools of client money in the event of a primary pooling event (this would allow for risks to be contained within a client base that has agreed to such risks while allowing other client money balances to be returned to clients in a timely manner).

**3.66** In addition, the Government will consider whether there are any steps to be taken with regard to the ability of clients to voluntarily waive their client money protection, as well as with regard to cases where an investment firm has failed to adequately segregate client monies.

**3.67** On the specific issue of client monies, the Government is aware that concerns exist with regard to the ability of clients to fully exercise their proprietary rights over monies that their broker may have placed within an overseas affiliate due to the treatment of that affiliate under local law. The Government acknowledges that there may be some issues with regard to the manner in which client monies are placed with investment banks where such firms employ a complex international affiliate structure and will be considering this issue further.

### **Possible changes to the way in which client money is segregated**

**3.68** The Government notes that it has been suggested that perhaps there could be a change to the client money rules so that rather than a single pool on insolvency, money is pooled based on different categories of client. For instance any clients trading listed products could perhaps form a separate pool to clients trading simple cash products. This could allow for the quicker return of assets to a certain category of client, and may protect one client from the risks associated with the activities of another set of clients.

### **Arrangements for set-off and liens**

**3.69** The Government believes that the application of set-off rights and liens in relation to amounts owing between an investment firm and its clients may also merit consideration. It has been suggested that there may be cases in which set-off rights following the failure of an investment firm could be applied in a manner that would reduce or negate the benefit of client asset protection. As a result of this, the situation for the client is arguably undesirable for several reasons:

- the client does not get the full protection of the FSA's client assets or client money protections because of the way in which the right of set-off has been applied;
- the client may be uncertain as to how the administrators intend to apply the right of set-off, in particular which of their assets may be sold to repay the margin loan. This means that it is more difficult for them to hedge the positions they continue to hold with the firm; and
- generally, assets that have not been rehypothecated tend to be the less liquid assets (the more liquid they are, the more likely it is for a firm to exercise rights of rehypothecation to raise funding for the firm). Therefore, it could be difficult to realise value for such assets at a price that is fair for the client or which reflects the client's expectation of the value of those securities. Moreover, any remaining assets will naturally be harder to hedge given their illiquid nature.

**3.70** The Government, in conjunction with the FSA, is therefore considering whether it would be appropriate to introduce requirements mandating the application of set-off in a manner that does not compromise customer asset protections.

**3.71** Such requirements could be introduced in consequence of any new customer property prioritised insolvency process that may or may not be introduced (as discussed in Chapter 4). It may also be possible for the issue to be addressed by way of amendment to the relevant prime brokerage agreements, since it is also a commercial matter between the parties; the Advisory Panel have noted that it seems likely that, in the current market context, customers will be looking to ensure that their agreements with the firms more adequately protect their interests.

## Establishment of bar dates to crystallise claims

**3.72** The Government notes that there may be difficulties with regard to the ability of clients to crystallise their rights over their assets and monies in the event of the failure of a major investment firm. The Advisory Panel has considered the idea that all claims for the return of client money and client assets should be made within a specified period following the insolvency of a firm holding such monies or assets (a bar date). In addition, there may be a case for requiring that pure custody assets should be returned within a shorter period.

**3.73** Any bar date that may be laid out should allow for sufficient time for the fact of administration to be publicised and for affected parties to calculate and submit their claims. Additionally, any such approach would need to consider carefully the feasibility of any time frames which may be established, having regard to practical difficulties in establishing claims, particularly where arrangements are complex.

**3.74** The viability of any such timescales will also be subject to the approach adopted in relation to set-off and liens by custodian banks and sub-custodians and any restrictions on the holding of client money and client assets with affiliated custodians (as discussed in Paragraphs 3.61 to 3.67). In addition it may be affected by the possibility, discussed in Chapter 4, of the appointment of an insolvency practitioner dedicated to the return of client assets, and the protection provided to such an insolvency practitioner in relation to the decisions made.

**3.75** In addition, the Government notes that there may be a case for best practice guidance for prime-brokerage agreements to be issued, requiring that they contain mutual insolvency events of default and netting provisions enabling the client to crystallise and value the investment firm's obligation to return rehypothecated securities and set off such amount against any liabilities owed by the client. Many existing contracts may at present not make full provision for the insolvency of the broker, and this may be a matter that can be usefully corrected through market practice.

## Possible changes to the regime around rehypothecation

**3.76** The Government notes that the flexibility that London maintains with regard to the establishment of rights of use to client assets is a core competitive advantage. London is an attractive venue for the conduct of investment banking activities in part because of the fact that the existing regulatory regime allows clients and their brokers the ability to choose the most appropriate arrangements for their particular business needs.

**3.77** While noting this important factor in any debate with regard to limits on rehypothecation, the Government notes that there may be practical benefits to the application of limitations, insofar as they could help to ensure the prompt return of assets. It has been suggested that clients could ensure that they negotiate and document a cap on the extent of rights of rehypothecation and clearly define in their legal agreements with brokers how that cap is to be quantified.

**3.78** Any change to the UK rules themselves should take account of the risk of such changes negating the attractiveness of the UK as a market in which to offer a leveraged securities financing or prime-brokerage service. The Government notes the views of market participants that the degree of rehypothecation for professional clients assets is a purely commercial matter.

**3.79** The Government notes that a possible regulatory reform to address certain concerns with regard to rehypothecation may be for the FSA to consider rules requiring investment firms to rehypothecate assets rateably across all holdings of a particular security.

**3.80** Finally, the Government notes that there is a need to avoid the possibility that any changes implemented in this area may impair the proper functioning of repo financing and liquidity in

the financial markets by undermining the certainty of English law as it applies to financing transactions utilising mechanisms such as title transfer.

### **Special officeholders and objectives for reconciling client assets**

**3.81** The Government notes that, when considering the timely return of assets and client money to customers in the event of insolvency proceedings, there are a number of stakeholders whose interests need to be balanced. Where the assets are encumbered (as the majority of customer assets held by investment banks are), there is a need to balance the interests of the creditors not to have property or rights of the estate removed from the estate, against the needs of the customers to have any of their assets that are not needed to discharge their obligations to the insolvent firm, returned to them in a timely manner.

**3.82** Given the interaction of these differing sets of interests, the Advisory Panel has considered whether it may be necessary to empower a new officeholder or agency to deal specifically with the client issues, thereby freeing the administrators to concentrate on securing the interests of the general estate, while a mandated individual focuses on securing a timely return of the client assets.

**3.83** The Government notes that there are a number of innovative and practical steps that could be taken in this area, and will work with the Advisory Panel to explore them further. That said, the Government is aware of the views of some market participants that it may be difficult in practice to separate the activities that need to be conducted to reconcile creditor and client positions.

**3.84** Any officeholders established under such a proposal could operate in pursuit of special insolvency objectives that may be laid out in legislation. This approach could also be made to operate with regard to the issues highlighted with regard to trading, clearing and settlement and is therefore laid out in greater detail in Chapter 4.

### **Establishment of 'bankruptcy remote' vehicles**

**3.85** The Government notes that a number of UK firms offering investment banking services are in the process of developing special purpose or 'bankruptcy remote' vehicles for holding client assets. These structures, which will vary depending on the approach being pursued by individual firms, are designed to enable customer assets that are not taken as collateral by way of title transfer, or that are being treated as excess collateral, to be released to customers promptly upon the insolvency of the firm. Should such structures prove effective they may operate as a market solution to the difficulty of securing the prompt return of client assets.

**3.86** The structures proposed would typically utilise a separate custodian entity whose sole function would be to hold certain of the securities in the customer's portfolio. While the custodian entity may be part of the investment firm's group, the Government understands that it would be established in such a way that it is insolvency remote to the investment firm's prime brokerage company and will continue to operate following the failure of the prime broker.

**3.87** In some cases firms are structuring the arrangements such that the prime broker has no security interest in the assets held by the custodian entity while other firms are retaining such an interest in favour of the prime broker but are exploring options for ensuring that such an interest will fall away upon insolvency. It may be possible for firms to receive legal opinions that such an approach would operate effectively, or, alternatively, it may be appropriate to investigate whether any such approach would require changes to legislation. The Government looks forward to receiving views on these points.

**3.88** Regardless of these questions, each variant of the approach is based around a common intention that, upon insolvency of the prime broker, the excess securities be free and clear of

encumbrances in favour of the prime broker upon the prime broker's default such that there is no impediment to the assets being released to the customer by the custodian entity, provided that there is sufficient clarity as to what is owed to that customer. The Government supports this objective, welcomes the steps that firms are taking to explore the creation of bankruptcy remote vehicles, and regards a market response in this area as useful.

**Question 9:** What are your views on how the Government can best address its objective of improving the speed of access of investors to their assets and monies which are held on trust?

## Maintaining Flexibility

**3.89** In taking forward any of the proposals discussed in this chapter, the Government is aware of the need to ensure flexibility for market participants, and to protect London's leading role as an international financial centre.

**3.90** The Government is keen to ensure that the implications of any proposals carried forward as a result of this work do not have substantial unforeseen consequences. It will therefore be important that any proposed solution is proportionate, practical and practicable, and avoids creating unnecessary complexity or burden. The financial services sector is constantly evolving and any proposed solutions would also need to be flexible enough to adapt to changing circumstances.

**3.91** Finally, it is important to note that the relationships in question in this chapter involve sophisticated investors, who professionally negotiate documentation, often with external counsel. The Government is not seeking to undermine the fundamental commerciality of such arrangements.

**Question 10:** What are your views on how the Government can best address its objective ensuring that sufficient flexibility is maintained in order to enable investors and brokers to arrive at mutually acceptable outcomes, and to ensure that any new regime is both 'future-proof' and has no substantial negative impacts?

**Question 11:** Do you have any other views on the issues of client assets and monies that you feel are important for the Government to consider?

# 4

## Achieving effective resolution

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**4.1** This Chapter includes proposals related to the insolvency process itself. The Government believes that there are a number of possible steps worth considering, in market, regulatory and other practice, and possibly through amendments to existing insolvency law, which might enable a more timely and effective response in the event of any future failure of an investment bank. These issues are cross-cutting, insofar as the effectiveness of the insolvency process itself is critical to the achievement of objectives laid out in both Chapters 2 and 3, as well as to protecting the general interests of creditors and the public interest in financial stability.

**4.2** The Government believes that there are a number of specific areas in which both insolvency law and practice might merit change. These include possible steps that could be taken both before and after a firm enters into insolvency, and steps that would need to be taken by individual market participants as well as by the relevant Authorities. Possible steps which the Government believes could be worth further consideration include:

- requiring firms to have full contingency plans for their own failure, or a 'business information pack' that could be presented to insolvency practitioners on day one;
- placing continuity of service obligations on the administrators of firms in insolvency proceedings, or on other relevant parties;
- amending insolvency law, such that practitioners operate on the basis of reduced liability, or in pursuit of special objectives laid out in statute to focus on the particular issues identified in Chapters 2 and 3; and
- establishing new roles for special insolvency officeholders.

**4.3** In considering these issues more fully, the Government will take account of wider market views. In addition, this work should be seen in the context of the broader reform agenda mentioned in Chapter 1, particularly the forthcoming paper in which the Government will describe its approach to the future of financial markets and set out the actions necessary to achieve it.

**4.4** Work in this area will also need to respect the framework of existing and well-developed insolvency practices in the UK, including the overarching principle of equal treatment of creditors, which ensures that foreign creditors are treated no differently from domestic creditors.

**4.5** In addition, looking to the future, the Government will also consider the appropriateness of the current process of administration, as it stands, for investment banks.

### Background

**4.6** The UK benefits from an insolvency regime which has evolved through hundreds of years of case law and statute and which strikes an appropriate balance between the needs of creditors and the needs of the insolvent company. Underpinning this regime is a targeted enforcement process, which ensures that those who have acted in a reckless or dishonest manner are dealt

with appropriately and their ability to damage the interests of creditors is restricted. Recent World Bank surveys<sup>1</sup> indicate that the UK insolvency regime is highly regarded, and that it has proved extremely effective in delivering results both for creditors in terms of speed and amounts recovered, and for debtors in reducing stigma and encouraging financial rehabilitation. The Government believes that this regime, as laid out in Box 4.A, remains, in principle, sound. It is important to note however that this does not preclude the possibility that it may be appropriate to make changes pertaining to investment banks if this review should find that they would be desirable.

#### **Box 4.A: Existing insolvency provisions for investment banks in UK law**

Under the UK's existing insolvency regime, an investment bank can be placed into compulsory liquidation or administration as provided for under the Insolvency Acts 1986 and 2000 (incorporating amendments made by the Enterprise Act 2002) and part 24 of the Financial Services and Markets Act 2000 (FSMA) (which adapts the Insolvency Acts for firms authorised by the FSA). These procedures apply the basic principle that the assets of the institution are to be gathered in, realised and distributed in the interests of all the creditors. Complementary secondary legislation includes the FSA Rules made under FSMA relating to the insolvency of investment firms.

Certain parts of an investment bank's business are subject to specific rules which take precedence over this general principle - for example Part 7 of the Companies Act 1989 which provides that for market contracts, the default rules of the clearing house or exchange take precedence over general insolvency where a member of that exchange or clearing house becomes insolvent. The Financial Markets and Insolvency Regulations 1991 make further provision in relation to Part 7. There is also secondary legislation stemming from various European Directives such as the Financial Collateral Arrangements (No. 2) Regulations and the Financial Services and Insolvency (Settlement Finality) Regulations 1999 which preserve certain prescribed collateral arrangements and settlement instructions in the event of insolvency proceedings being commenced against an investment firm.

**4.7** The Government notes that the activities of modern banks, and in particular investment banks, present particular resolution challenges in times of crisis. Notwithstanding the real strengths of the UK insolvency regime, it is clear that the insolvency of any complex banking business will always present substantial practical and logistical difficulties in achieving a swift and fair distribution of assets to creditors. The failure of an investment bank may also bring particular difficulties, in addition to the challenges identified in Chapters 2 and 3.

**4.8** The Government recognises that there are instances where it would not be in the wider public interest for the normal laws of insolvency to apply to a certain industry or sector. Special insolvency regimes (such as the recently introduced bank insolvency procedure and bank administration procedure, which apply to deposit-taking banks) operate to modify normal insolvency legislation to achieve specific policy objectives, the achievement of which would be hampered were 'normal' rules to apply. Such special administration regimes operate in clearly defined niches on the periphery of insolvency law and by their very nature are used far less often than normal administrations. Generally, they seek to ensure the continuity of services that might otherwise be interrupted by the onset of insolvency.

<sup>1</sup> The World Bank's "Doing Business Report 2009" ranks the UK joint 8<sup>th</sup> out of 155 countries for the speed with which it deals with troubled businesses; and 9<sup>th</sup> out of 155 countries for the amount recovered for creditors. This compares with joint 23<sup>rd</sup> and 15<sup>th</sup> for the US, joint 37<sup>th</sup> and 40<sup>th</sup> for France and 20<sup>th</sup> and 33<sup>rd</sup> for Germany

**4.9** As indicated above, the Government believes that the administration regime (and the insolvency system generally) is robust and fit for purpose – accordingly this Chapter does not seek to discuss altering the fundamental principles of UK insolvency law but, rather, seeks views on discrete areas where normal administration may not answer all the policy needs that might arise when an investment bank (commonly a complex entity) faces inevitable insolvency or enters into administration.

**4.10** As discussed in Paragraph 4.2 above, the Government considers that there are a number of steps which could be taken to address the particular difficulties faced in applying existing insolvency procedures to investment banks, some, but not all of which, would involve changes to legislation.

**4.11** This chapter therefore considers these issues from three perspectives:

- **firm-level failure management;**
- practical steps which might taken to ensure **an orderly insolvency process;** and
- legislative steps, covering **possible areas of reform to UK insolvency law**

The Government considers that these approaches would be complementary. They are described in detail below.

## **Firm-level failure management**

**4.12** The Government is of the view that there is more that could be done at a firm-level to ensure the effectiveness of any insolvency process into which the firm itself may enter. It is perhaps unsurprising that individual institutions do not expend substantive resource in planning for their own failure, but the Government believes that, in the event of an insolvency, such pre-failure actions may be critical not only to securing effective outcomes for the estates, but also to securing confidence in the financial system and financial stability generally. Firm level failure management is therefore in the interests of clients and creditors, as well as the industry as a whole.

**4.13** The Government is presently considering two primary approaches with regard to firm-level firm management, these are discussed in the following sub-sections:

- **contingency plans;** and
- **business information packs.**

**Question 12:** What role do you think firm-level failure management should play in the resolution of investment banks?

## **Contingency plans**

**4.14** One option in respect of firm-level failure management might be for investment banks to take steps to prepare detailed contingency plans - including staff and remuneration arrangements - which would allow client asset systems, trading positions and reports to run in an insolvency situation. The aim would be to ensure the creation of systems and contingency plans which would enable the continuity of customer asset protection and record keeping, and that are capable of being easily implemented at short notice upon a firm entering insolvency proceedings. The Government and the FSA will consider this option further.

**4.15** This might help to address some of the difficulties which emerged in the Lehman Brothers' case with regard to the ability to retain staff and ensure continuity of service; the difficulty being

that staff who lack a clear indication that they will receive payment lack incentives to provide an ongoing service.

**4.16** The Government notes that large firms offering investment banking services are highly likely to have in place business continuity and contingency arrangements that would apply in the case of system failures, or major business disruptions. It may therefore be the case that the costs involved in the extension of such systems to cover the failure of the firm itself may not be prohibitive.

**Question 13:** What are your views on the potential costs of ensuring continuity and contingency arrangements?

**4.17** There may be a need for continuity of service obligations to be laid out in amendments to insolvency law, as set out in Paragraph 4.34 below, but the Government recognises that there may instead be scope for some of this work to be covered on a voluntary basis by investment banks themselves. Such steps may prove to be in the interests of the relevant firms, insofar as they would accrue reputational benefits and be able to provide assurance to both clients and their own investors that they would fair comparatively well (at least compared to firms not employing such failure planning) in an insolvency event.

**4.18** There may prove to be difficulties with such a market solution, perhaps as a result of cost implications, or a view that such an approach could suggest structural weakness on the part of first mover firms choosing to employ it. Should a market solution in this area prove difficult to arrive at independently, there may be a case for considering regulatory action to ensure the creation of fully effective contingency plans.

**4.19** With regard to any such approaches, there may be a case for requiring larger, or more systemically important, investment banks to produce such plans and to address certain system weaknesses (from the point of view of such contingency planning), while providing exemptions for smaller market participants. The danger here however would be that a two-tier system could be created.

**4.20** Finally, the Government recognises that investment banks are participants in many other entities that underpin the financial system; commonly these will be exchanges, clearing houses, custodians and settlement systems. It is important to ensure that existing cross-firm and infrastructure-based default management processes are enhanced by any work at a single firm level. The Government notes that a number of market bodies are exploring steps in this regard, the Futures and Options Association is collaborating with LCH.Clearnet to explore default management contingency planning for their industry segment for example. There may be a case for exploring such initiatives further.

**Question 14:** What other factors should be considered with regard to contingency and continuity planning?

## **Business information packs**

**4.21** Another option the Government is considering with regard to firm-level failure management would be to focus on the informational aspects of difficulties with regard to insolvency proceedings.

**4.22** One of the problems facing any insolvency officeholder appointed in respect of an investment firm is coming to grips with, and understanding, the nature of the business in a very

short period of time. The administrators of Lehman Brothers International (Europe) (LBIE) were given less than 12 hours' notice of their appointment and so had very little time in which to familiarise themselves with the business model and activities, operational and IT systems, structure and key personnel of the firm.

**4.23** In this regard, it may be helpful if investment firms were required to keep a business information pack which could be made available to any insolvency officeholder on day one. This might be annually reviewed, for example by the FSA as part of its regular supervisory function, or by the firm's auditors, and could take the form of a manual or pack which would:

- describe the firm's IT systems and software (and the likely impact of any failure of an overseas parent or other group company on such systems);
- describe the systems that the firm uses to book trades (including actual settlement in addition to any contractual settlement systems);
- include details of all custodians, sub-custodians, intermediaries and clearing or settlement systems used by the firm (Chapter 3 above also makes suggestions regarding reporting by the firm to its clients regarding the use of custodians);
- include brief descriptions of the key work streams undertaken by the firm and the types of contract used for doing business;
- include organisational charts showing how the investment firm sits within any wider group structure; and
- describe employment structures and give details of key staff and their areas of responsibility.

**4.24** Such a manual would assist the insolvency officeholder in coming to grips, very quickly, with the business, to minimise the period of distribution to the market and facilitate the settlement of trades or the return of client assets in a timely manner.

**4.25** The implications of any such requirements would need to be considered against the cost impacts for firms, since there would be a need to ensure that such business information packs were kept up to date. As with the contingency proposals laid out above, there may be a case for requiring larger, or more systemically important, investment firms to produce such packs, while providing exemptions for smaller market participants.

**4.26** The Government will consider these proposals further in conjunction with the Advisory Panel and welcomes views from market participants.

**Question 15:** What other factors should the Government bear in mind when considering business information packs?

**Question 16:** Are there other approaches should the Government consider in asking firms to take steps to prepare for their own failure?

## **An orderly insolvency process**

**4.27** The Government believes that, in addition to the pre-failure steps which may be taken by firms themselves, there may be a role for examining how major insolvency processes might be

made more orderly by the involvement on a practical and operational level by the Authorities, in conjunction with both failing firms and insolvency practitioners.

**4.28** As discussed in Chapter 1, there has been some market commentary on the distinctions between the ways in which the Lehman Brothers' insolvency was handled in the UK and elsewhere. The Government, and the Advisory Panel, are of the view that the UK insolvency regime compares favourably to that of other jurisdictions in the outcomes that it typically provides.

**4.29** The Government notes however that there has been a perception that the liquidation of Lehman Brothers International (LBI), the US parent of LBIE, appeared to have been more orderly in the first few days after the failure of the group became apparent on 15 September 2008 (see Box 4B). The Government believes that, insofar as this is the case, this was largely as a result of practical actions taken prior to the commencement of LBI's liquidation, rather than being a function of the different regulatory and insolvency regimes employed in the US.

**Box 4.B: Managed wind-down and resolution of Lehman Brothers Inc (LBI) and Lehman Brothers Holding Inc (LBHI)**

On 15 September, after LBHI had filed for bankruptcy protection, the Securities Investor Protection Corporation (SIPC), announced that LBI appeared to have properly kept customer cash and securities separate from company accounts, that the customers of LBI could continue to access their accounts and that there were no missing customer assets. This appears to have provided a helpful context within which regulatory authorities and various stakeholders could work together to achieve pragmatic solutions to deal with customer assets and money and to minimise market disruptions.

Intra-day liquidity was provided by JP Morgan and Citibank under their respective clearing agreements with LBHI and its subsidiaries (including LBI). The liquidity provided by Chase and Citibank in what was clearly likely to be a pre-bankruptcy period was facilitated by two orders issued by the court in LBHI's proceedings which confirmed that Chase's and Citibank's respective claims for any advances made to LBI during this time would have special protections under the Bankruptcy Code. By 15 September, both the Financial Industry Regulatory Authority (FINRA) and the Securities Exchange Commission (SEC) were on-site at LBI to oversee the orderly transfer of customer assets to one or more SIPC-insured brokerage firms in an effort to minimise the impact of LBHI's failure on LBI's customers.

**4.30** Recognising this, the Government believes that there is a case for considering options for developing a set of proposals for a pre- and post-insolvency process of 'managed failure' when dealing with investment banks. This would enable the relevant parties to coordinate an improved response to client or other needs. Such options might include:

- firm-level pre-insolvency engagement. This could involve more intensified engagement with a firm at a pre-default stage (perhaps a few days prior to insolvency) to prepare the ground for the possibility of it entering into insolvency on a more orderly basis, with improved continuity of service providing for a less challenging task for administrators, and, potentially, greater market certainty
- support for administrators. In addition, it might be appropriate to provide practical, legal or other support during the initial stages of an insolvency process, recognising the general public interest in an effective resolution of major investment banks; and
- engagement and communication with the market. There might be steps that can be taken to provide more effective and coordinated communication with the market in the event of

a major investment bank failure. This could include early announcement of defaults, and clarity around the steps that are likely to be taken.

**4.31** The Government will consider all of these possible approaches. It will also consider the framework under which such approaches could be taken forward. The Government notes that the UK has been successful in operating under a clear and constructive framework with regard to the resolution of deposit-taking firms.

**Question 17:** What are your views on the steps the Authorities may take in engaging with failing firms, administrators and the market in the event of the failure of an investment bank?

## Possible areas of reform to UK insolvency law

**4.32** In addition to the above, the Government is considering a range of possible reforms to specific areas of insolvency law which may be appropriate in supporting an orderly process for the resolution of failing investment banks. At present, these include the possibility of introducing;

- continuity of service obligations;
- changes to the initiation process for insolvency;
- greater freedom for insolvency practitioners;
- a special insolvency regime;
- special insolvency officeholders; and
- other possible resolution tools.

**4.33** The proposals in this section are under active consideration, and the Government would welcome views on the most appropriate approaches, or combination of approaches, to take forward. That said, the Government notes that a number of the steps discussed below are directed at similar outcomes, and it may not necessarily be appropriate to proceed with all of the approaches described.

**Question 18:** What are your views on the steps the Government should consider with regard to establishing an orderly insolvency process for investment banks?

## Continuity of service obligations

**4.34** The Government is aware that in resolving the failure of a large and complex firm it is important that there is effective access to the systems which support that firm's normal operations, if such a resolution is to proceed on a basis which effectively addresses the issues laid out in Chapters 2 and 3. A functioning IT system, for example, is critical; Box 4.C describes the consequences of the collapse of Lehman Brothers' IT function.

#### **Box 4.C: Collapse of Lehman Brothers' IT function**

As a globally integrated firm, Lehman Brothers' IT operations were structured on an inter-group basis. Lehman Brothers had 2,000 IT applications across the globe, with 29 data centres and 26,500 servers operated by 6,000 IT employees. This infrastructure was vital to the operations of all parts of the group, and collapsed on 15<sup>th</sup> September 2008. The failure of this function has materially affected the ability of administrators to address issues around open client positions and other issues.

**4.35** In addition to the steps which may be taken at a pre-insolvency stage by firms and other parties, the Government is therefore considering whether it may be necessary to introduce some form of continuity of service obligations upon the administrators of the insolvent estate, providers of systems support to the estate, or other relevant parties, with regard to ensuring effective settlement (or clear cancellation) of open positions and securing a prompt return of client monies and assets.

**4.36** There are two possible elements to this. It might be appropriate to place obligations upon administrators themselves, such that they were required to address issues related to open positions and client assets. However, it is worth noting in this regard that the administrators may still not be able to act effectively if they lack control of support systems necessary to act effectively. The second possible element to the introduction of continuity of service obligations would therefore focus upon providers of necessary systems, whether other affiliates or parts of the group structure of the insolvent firm, or third party contractors and suppliers.

**4.37** It is not uncommon for businesses, particularly investment banks, to organise various support services in separate entities within a group and to locate these in different countries. The continued operation of a business depends upon continued access to, and service provision from, these group companies; for example data centres based in other countries. The corollary is that consideration must be given to the need for administrators to have access to, and receive co-operation from, other group companies and outsourced service providers.

**4.38** Market and regulatory actions may already address some aspects of these issues and may develop to provide sufficient and proportionate solutions to many of the requirements, particularly if firm-level contingency planning, as discussed above, is effective.

**4.39** However, in cases where it is not, the Government will consider whether it may be appropriate to set statutory requirements to provide essential services. Options may include the establishment of a specified insolvency regime similar to that provided for in Part 3 of the Banking Act 2009 (see Box 4.D) or the introduction of the continuity obligations that it contains.

#### **Box 4.D: The Bank Administration Procedure in the Banking Act 2009**

Part 3 of the Banking Act establishes a Bank Administration Procedure (BAP). This is used to secure continuity of service from the residual entities, which may be created through the use of the Special Resolution Regime (SRR), which is established in the Act.

Where the Bank of England effects a partial transfer under the SRR (using either the private sector purchaser or bridge bank stabilisation options), the residual bank is likely to be rendered insolvent. In the event that the bridge bank or private sector purchaser is dependent on the residual company, or a group company, for the continued operation of the business, the new procedure provides a framework to ensure that essential services are provided to the transferee (either the private sector purchaser or the bridge bank).

In particular, where it is not possible to transfer contracts for services relating to the failing bank to the purchaser (for example, the IT systems of the failing bank that may be subject to foreign law governed non-assignment clauses), and these services are essential for the continued operation of the business transferred to the purchaser, the administrator would be placed under a duty to supply those services to the purchaser.

As soon as it is no longer necessary for the insolvent residual company to provide support services and facilities to the private sector purchaser or bridge bank, the proceedings continue in a similar way to a normal administration.

**4.40** The Government notes that there are difficulties with this approach however, as it would be difficult to extend obligations to third party service providers. There are also difficult balances to be struck between requiring other entities to provide services even if compensated for that and any solutions will need to recognise the possibility that other group companies may themselves have become insolvent and be subject to proceedings in other countries. Any such provisions would also have to be balanced against the risks and obligations to the insolvent estate.

**Question 19:** What are your views with regard to continuity of service obligations in the event of investment bank insolvency?

### **Changes to the initiation process for insolvency**

**4.41** There are a number of foreseeable circumstances in which a greater degree of discretion for directors as to the timing of the commencement of a formal insolvency process might prove of value, both for wider market stability, and for creditors themselves.

**4.42** At present there is no direct obligation upon directors to commence a formal insolvency process but a very strong incentive is provided by provisions of the Insolvency Act 1986 which renders a director liable for certain losses and possible disqualification where they fail to take every possible step to minimise loss to creditors when insolvency is inevitable. The Government believes that it may be appropriate to investigate whether this threat might operate against the wider interest (of creditors themselves, as well as the public interest in terms of financial stability) in having a longer handover to administrators in the case of some complex or systemically important firms.

**4.43** That said, any such amendments would need to be considered extremely carefully, and would need to be limited in scope.

**Question 20:** What are your views on possible changes that could be made to the incentives around the initiation of insolvency proceedings?

## Greater freedom for insolvency practitioners

**4.44** As the regime around personal liability for insolvency practitioners involved in the administration of investment banks currently stands, there may be incentives for them to seek to secure a high degree of confidence before releasing client assets or settlement accounts, or taking other steps which may be of benefit to market confidence and financial stability. This high degree of confidence may be wholly out of step with the levels at which a prudent director running a business might be accustomed to act. Unlike with an ongoing business, such decisions may have an immediate and measurable impact upon the return available to creditors.

**4.45** In complex cases involving the insolvency of investment banks, administrators may feel constrained from taking steps that would be in the interest of both clients and creditors due to the possibility of very substantial liability accruing in an unforeseen manner. For example, it would be of considerable benefit to clients should administrators allow the processing of outstanding trades, but practitioners may feel constrained by possible personal liability due to any losses that may occur as a result of trading activity following insolvency.

**4.46** It may be the case that insolvency practitioners would in practice be able to act with greater speed should liability arrangements be amended, in complex cases. Advisory Panel members have suggested that exemptions from liability to creditors could be established in respect of the return of client assets, possibly based on a release of unencumbered assets subject to a reasonable pre-estimation of the parties' obligations subject to a subsequent estimation. Similar exemptions from liability could also be created in respect of actions taken pertaining to open positions. There may also be proper occasions for releasing assets from a liquidity point of view but reserving a right to recover them or their value later.

**4.47** The Government will consider this issue further, including possible proposals for how liability may be amended, such as through the retention of liability with a good faith test. Under this approach, insolvency law might be amended so as to provide some level of statutory protection to an administrator for decisions made with respect to the return of client assets, or the closure of outstanding positions, where they are made in good faith and on reasonable grounds.

**4.48** Any steps taken in this regard will need to be duly considered in the context of other possible amendments to insolvency law discussed in this chapter, and may not be necessary if any separate set of proposals affecting the insolvency process were to be taken forward.

**Question 21:** What are your views on reducing or amending arrangements concerning liability for insolvency practitioners?

## A special insolvency regime

**4.49** In addition, the Government is considering whether it might be appropriate to institute, through the regulation-making powers established in the Banking Act, a special insolvency procedure for investment banks. The advantage of such a special procedure would be that it could enable the creation of specific objectives pertaining to the issues laid out in Chapters 2 and 3 above, to which administrators would be required to have regard in the event of an insolvency.

**4.50** In particular, a special insolvency regime for investment banks could require an administrator to prioritise the return of client assets, or to cooperate fully with settlement banks and other infrastructure providers to expedite the closing out of open client positions. At present the administrators are required to act in a way that meets the statutory purposes of administration as provided in the Insolvency Act 1986. In broad terms, this requires the administrators to act in the general interests of creditors as a whole, not to favour particular groups of creditors. Therefore, there is no legal basis on which the administrators could treat the distribution of client assets with any higher priority than conducting the administration of an investment bank for the benefit of the general creditors.

**4.51** In addressing such difficulties there are a number of options for how any such special regime could operate. For example, it is unclear whether a single objective would be sufficient, or whether any regime would give more detailed direction to insolvency practitioners involved in the administration of an investment bank. But, options would include:

- with regard to client assets, a special objective could require administrators to place a primary focus on the prompt return of such assets to clients. The purpose of this provision would be to achieve greater clarity as to the treatment of client assets and a faster payout to clients; and
- with regard to open over the counter (OTC) positions a provision could require practitioners to enter instructions to delete any outstanding, unsettled transfer orders, which would then be match-deleted by the non-defaulting counterparty. The purpose of this provision would be to allow a given period after the insolvency of one party for settlement of an OTC trade to take place but to remove the possibility of the trade settling after the expiry of a defined period or following a specified event or in specified circumstances. It would be applied where a investment bank had entered settlement instructions into CREST for the settlement of OTC trades and then had become the subject of insolvency proceedings; the administrator of the insolvent financial institution could, under this proposal, be required to instruct CREST to delete the settlement instruction for all such trades. It is not clear, at this stage, how such an approach with regard to open positions would be integrated within an approach that dealt with any prioritisation of client assets, and therefore any special objective may need to be dynamic, and potentially multi-faceted in nature.

**4.52** Clearly the implications of any procedures of this kind would also need to be considered in terms of the effects which they may have on general creditors and the estate as a whole; any unqualified duty to focus on the return of client assets, for example, may lead to additional (and potentially substantial) delays in the return of assets to general creditors.

**4.53** In addition, the Government recognises the value in maintaining clarity and simplicity around the UK insolvency regime wherever possible. The implications for this of establishing a further special regime will be considered extremely carefully, and the Government considers that any such proposal would have to pass a high ‘needs test’ before being taken forward.

**4.54** The Government is of the view that, should a special objective ultimately prove to be desirable, steps should be taken to ameliorate any impacts on standard insolvency practice. The Bank Insolvency Procedure in the Banking Act, which was established with regard to the insolvency of deposit taking firms (see Box 4.E), provides a precedent for how such an objective may function, insofar as it establishes a special objective while at the same time ensuring that the interests of general creditors continue to be reflected in the amended insolvency process.

#### **Box 4.E: The Bank Insolvency Procedure in the Banking Act**

Part 2 of the Banking Act establishes a new Bank Insolvency Procedure (BIP), based largely on existing liquidation provisions, to provide for the orderly winding up of a failed bank and to facilitate rapid Financial Services Compensation Scheme (FSCS) payments to eligible claimants, or a transfer of such accounts to another financial institution. The liquidator of the bank will have specific statutory objectives:

- to work with the FSCS to enable prompt payouts to eligible depositors or to facilitate the bulk transfer of accounts to another institution; and
- to wind up the affairs of the failed bank in the interests of creditors as a whole.

Building on the strength and effectiveness of the UK's existing insolvency regime, the BIP closely follows existing insolvency law and practice but gives priority to the immediate payout/transfer of eligible depositors.

**4.55** The Government would also need to consider carefully how any proposals for a special regime would interact with other policy approaches, for example any special officeholders who may be appointed, as described in Paragraphs 4.56 to 4.61 below. The Government also recognises that a number of special insolvency regimes now exist (as indicated in Chapter 1), most notably the recent provisions for deposit-taking banks in the Banking Act, and that clarity around any interaction with these provisions will be particularly important.

**Question 22:** What are your views on the possibility of creating a special insolvency regime for investment banks?

### **Special insolvency officeholders**

**4.56** In addition to, or in conjunction with, proposals around special objectives for insolvency, a further option is to consider the establishment of new sets of roles and responsibilities in an insolvency (and potentially in a pre-insolvency) situation.

**4.57** The Advisory Panel considered proposals around an office, or officeholder, specifically tasked to deal with client assets at both the pre- and post- insolvency stage. In addition, with regard to the issues identified in Chapter 2 of this paper, the Advisory Panel considered whether it may be necessary to provide mandates for officers involved in the resolution of open positions. Insofar as it pertained to client assets, such an agent or office may be designated as a 'Client Asset Officer' or a 'Client Asset Agency' and would be independent of the administrators of the estate. Upon the initiation of insolvency proceedings in respect of the firm, the officeholder, or agency, would work alongside the administrators, who would retain responsibility for the creditors of the general estate.

**4.58** Where assets are unencumbered the officer would be able to return assets promptly based on custody records kept by the insolvent firm. This would require that record keeping was adequate, which may not be the case in all circumstances, but which could be encouraged through the use of measures identified in Chapter 3. Where assets are encumbered in favour of the insolvent entity only, and the relevant customer documentation contains a termination and set-off clause which has been activated by the customer as a result of the firm's administration, the officer could have the power to release assets based on an estimation of the secured claims of the insolvent broker on the client and the client's obligations to the broker. It may be necessary to ensure that the officer would not, in such a scenario, have any personal liability to

the creditors for any distribution of assets made based on the net exposure records kept by the firm.

**4.59** A number of steps could be taken to protect the operational effectiveness of any such officeholder. In particular, a bar date on trust claims for distribution by the officer could be created. It may be necessary to determine that a distribution by the officer would not terminate the right of administrators to subsequently challenge sums estimated or values used in a set-off calculation but it cannot hold up a distribution made by the officer.

**4.60** The Government notes that because of the long and short nature of many client portfolios, valuation discrepancies may work either in favour of or to the detriment of the creditors of the insolvent firm in a rising or falling market, not possible to say that the firm will always be disadvantaged by this methodology. The distribution need not terminate the ability of either client or firm to subsequently challenge the valuations and recover a cash claim and the client asset officer could be able to make such a distribution without any liability for the same where it is made in good faith.

**4.61** The Government considers that there may be merit in exploring these proposals further. However, any steps to do so would have to consider a number of practical factors with regard to cooperation and engagement with the administrators of any firm which may be in insolvency proceedings.

**Question 23:** What are your views on the possibility of creating special insolvency officeholders? How should such officeholders interact with other insolvency practitioners?

### Other possible resolution tools

**4.62** The Government does not, at present, believe that wholesale changes to existing insolvency law are appropriate. It intends to produce effective outcomes which require as little alteration to existing legislation as possible.

**4.63** Notwithstanding this, the Government remains committed to investigating all aspects of current insolvency legislation, as it pertains to investment banks, that may be able to be improved. The Government would therefore welcome any views on other aspects of insolvency law and practice, including administration processes, relevant to the resolution of investment banks.

**Question 24:** Do you have any comments on other aspects of insolvency law, including administration processes, in relation to how they affect investment banks? Are there any other factors you think the Government should consider with regard to developing effective resolution arrangements for investment banks?



# 5

## Summary of questions

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The Government would welcome views on the following questions.

### Chapter 2 – Trading, Clearing and Settlement Issues

**Question 1:** Are there any other principles that you believe the Government should consider in addressing its first objective of protecting the diversity and choice of trading, clearing and settlement methods for market participants?

**Question 2:** How do you think the Government can best address the second objective, that of ensuring clarity, and building an environment in which the reasonable expectations of market participants with regard to trading, clearing and settlement are consistently matched with outcomes?

**Question 3:** The Government would welcome views on whether a market-led or statutory approach to ensuring contractual certainty is appropriate. In particular the Government would welcome views on, if market participants were to develop a protocol for determining the outcome of the contractual position of the underlying parties to the trade, what might need to be done under Part 7 of the Companies Act or otherwise to ensure the protocol is effective?

**Question 4:** How might the Government best address the third objective, ensuring that clear and flexible contractual arrangements can be applied consistently in a manner which secures legal certainty with regard to trading, clearing and settlement?

**Question 5:** How might the Government best address the fourth objective, developing appropriate market and regulatory responses to the technical challenges surrounding uncertainty with regard to the trading, clearing and settlement of trades not executed on recognised exchanges in the event of insolvency proceedings?

**Question 6:** Do you have any other views on the issues of trading, clearing and settlement that you feel are important for the Government to consider?

### Chapter 3 – Client Assets and Monies

**Question 7:** What are your views on how the Government can best address its objective of ensuring clarity with regard to the ways in which client assets and monies are treated on insolvency, and addressing misconceptions as to the protections in place?

**Question 8:** What are your views on how the Government can best address its objective of improving transparency by facilitating the identification and legal categorisation of client assets and monies following the commencement of insolvency proceedings and the legal categorisation of a client's rights in respect of those assets and monies?

**Question 9:** What are your views on how the Government can best address its objective of improving the speed of access of investors to their assets and monies which are held on trust?

**Question 10:** What are your views on how the Government can best address its objective ensuring that sufficient flexibility is maintained in order to enable investors and brokers to

arrive at mutually acceptable outcomes, and to ensure that any new regime is both 'future-proof' and has no substantial negative impacts?

**Question 11:** Do you have any other views on the issues of client assets and monies that you feel are important for the Government to consider?

#### **Chapter 4 – Achieving Effective Resolution**

**Question 12:** What role do you think firm-level failure management should play in the resolution of investment banks?

**Question 13:** What are your views on the potential costs of ensuring continuity and contingency arrangements?

**Question 14:** What other factors should be considered with regard to contingency and continuity planning?

**Question 15:** What other factors should the Government bear in mind when considering business information packs?

**Question 16:** Are there other approaches should the Government consider in asking firms to take steps to prepare for their own failure?

**Question 17:** What are your views on the steps the Authorities may take in engaging with failing firms, administrators and the market in the event of the failure of an investment bank?

**Question 18:** What are your views on the steps the Government should consider with regard to establishing an orderly insolvency process for investment banks?

**Question 19:** What are your views with regard to continuity of service obligations in the event of investment bank insolvency?

**Question 20:** What are your views on possible changes that could be made to the incentives around the initiation of insolvency proceedings?

**Question 21:** What are your views on reducing or amending arrangements concerning liability for insolvency practitioners?

**Question 22:** What are your views on the possibility of creating a special insolvency regime for investment banks?

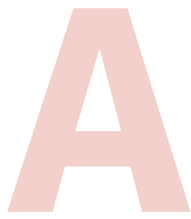
**Question 23:** What are your views on the possibility of creating special insolvency officeholders? How should such officeholders interact with other insolvency practitioners?

**Question 24:** Do you have any comments on other aspects of insolvency law, including administration processes, in relation to how they affect investment banks? Are there any other factors you think the Government should consider with regard to developing effective resolution arrangements for investment banks?

#### **Annex B – Consultation Stage Impact Assessment**

**Question 25:** What are your views on the proposed approach to a future impact assessment on potential proposals in this area?

**Question 26:** What sources of evidence or data would you recommend referencing (or could help provide) that can be used to help to estimate the costs and benefits of future proposals?



# The consultation process

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## How to respond

**A.1** The Government welcomes comments on the questions posed in this consultation paper. Any comments should be sent to:

Investment Bank Insolvency  
3/09  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

Tel: 0207 270 4716  
Email: alex.white@hm-treasury.gov.uk

**A.2** Comments should be received by 10 July 2009.

## Confidentiality disclosure

**A.3** Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

**A.4** If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information that you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

**A.5** In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless an explicit request for confidentiality is made in the body of the response.

## Code of practice for written consultation

**A.6** This consultation process is being conducted in line with the Code of Practice for written consultation ([www.cabinetoffice.gov.uk/regulation/code.htm](http://www.cabinetoffice.gov.uk/regulation/code.htm)) which sets down the following criteria:

- consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy;
- be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses;

- ensure that your consultation is clear, concise and widely accessible;
- give feedback regarding the responses received and how the consultation process influenced the policy;
- monitor your Department's effectiveness and consultation, including through the use of a designated Consultation Co-ordinator; and
- ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

**A.7** If you feel that this consultation does not fulfil these criteria, please contact:

Angela Carden  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

Email: [angela.carden@hm-treasury.gov.uk](mailto:angela.carden@hm-treasury.gov.uk)

# B

## Consultation stage impact assessment

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**B.1** This paper establishes the Government's initial thinking with regard to developing effective resolution arrangements for investment banks. It is designed to inform a full consultation document to be published by the early autumn, which will be accompanied by a detailed impact assessment.

**B.2** The possible approaches to the resolution of failing investment banks that are described in this paper are deliberately high-level at this stage, and the Government has not decided which, if any, proposals will be taken forward. It is not therefore appropriate at this stage to attempt a full impact assessment, or a cost-benefit analysis of steps which may, or may not, be taken forward.

**B.3** The Government is committed however to following appropriate best practice and producing as full an impact assessment as is appropriate and practicable in later consultation documents, where policy approaches are more finalised.

**B.4** The Government anticipates that it may be appropriate to produce a detailed impact assessment alongside the consultation paper to follow this one, which will be published by the early autumn. It is intended that this will give a broad picture of the impact to the economy of future proposals. The aim of that impact assessment will be to establish, as far as possible, the costs and benefits of any proposed changes to the insolvency regime for investment banks.

**B.5** The Government is actively considering the methodology that will be used in such cost benefit analysis. Data from the impacts of previous insolvencies of large complex financial institutions will be considered, though it should be noted that any quantification of the costs and benefits of financial stability is, by its nature, challenging.

**B.6** The potential benefits that will be considered will include those accruing from a more prompt return of client assets and monies and greater certainty around the treatment of open positions on default. Benefits under consideration will also include the impacts of maintaining the international competitiveness of the City of London.

**B.7** The potential costs that will be considered will include any new burdens or restrictions that may be associated with introducing any of the proposals laid out in subsequent consultation papers.

**Question 25:** What are your views on the proposed approach to a future impact assessment on potential proposals in this area?

**Question 26:** What sources of evidence or data would you recommend referencing (or could help provide) that can be used to help to estimate the costs and benefits of future proposals?





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