



**STATE STREET.**  
For Everything You Invest In™

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The Financial System and Major Operational Disruption  
FSM Team  
Room 4/16  
H.M. Treasury  
1 Horse Guards Road  
London SW1A 2HQ  
The United Kingdom

Dear Sir or Madam:

We would like to thank Her Majesty's Treasury for affording State Street Bank and Trust Company the opportunity to comment on *The Financial System and Major Operational Disruption*, which we refer to in this letter as "the consultation paper." State Street is the world's leading specialist in providing sophisticated global investors with investment servicing, investment management, investment research and trading services. With US\$6.2 trillion in assets under custody and US\$763 billion in assets under management (both as of December 31, 2002), State Street is headquartered in Boston, Massachusetts, has major offices in London and Edinburgh, and operates in 21 countries and over 100 markets worldwide.

#### **Introduction**

State Street believes that the approach outlined in the consultation paper is, when viewed most favorably, only one piece of a far more significant and practical plan of action that is needed from the government, regulators and the industry, to ensure the coordinated and efficient recovery and resumption of market activity in the event of a catastrophic event. Rather than proposing legislation to increase the government's power for direct market intervention, State Street recommends that the UK Government use its existing powers to:

- Create capabilities and processes to enhance communication within the private sector and between the public and private sector during a catastrophic event – whether caused by natural disaster, technology disruption, telecommunications disruption, human actions, cyber terrorism or otherwise.
- Provide safety net mechanisms to the financial markets as needed during the disruption, including liquidity and the relaxing of regulatory constraints



- Facilitate the creation and testing of robust business continuity solutions and plans for both systems and business operations

By pursuing these activities, the UK Government, regulators and the Bank of England will enhance the ability of the financial markets to withstand a major catastrophic event and return to normal operations quickly. We believe that the benefits of adopting powers of suspension and direction, as proposed, are far outweighed by the problems described below.

### **Role of Government, Regulators and Central Banks**

In the United States and the United Kingdom, market disruption events in the past have demonstrated that the most valuable role played by government and regulators was to take pragmatic steps to facilitate a market-based approach to resolution of various aspects of the crisis, under their watchful eye. The aftermath of the 1987 hurricane in the United Kingdom and the events of September 11, 2001 in the United States demonstrated that cooperation involving market participants and the authorities worked well at a time of severe disruption. Participants and regulators worked together to resolve issues voluntarily and ensure that disruption was minimized and conditions returned to normal as soon as reasonably practicable. The financial, governmental and regulatory entities did not attempt to assume control of and manage the situation directly, by fiat or otherwise. Rather, after September 11<sup>th</sup>, the US Federal Reserve made significant funding available to preserve liquidity in the financial system. The US Securities and Exchange Commission relaxed a number of regulatory requirements relating to disclosure, capital requirements and affiliated transactions. These actions helped to stabilize the markets after they reopened.

In the aftermath of September 11<sup>th</sup>, the financial regulators in the United States have been reviewing an array of market continuity issues across the financial sector, including reviewing geographic and activity concentration risks, establishing guidelines for “core” clearing and settlement organizations and “significant” firms that play a major role in critical financial markets. Indeed, on April 8<sup>th</sup>, 2003, the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, and the Office of the Comptroller of the Currency jointly issued their final *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System*, which reflects a cooperative consultation effort and incorporates many of the changes proposed by financial market participants. The general approach, as well as the final paper, have been well received and viewed as a successful model for future efforts. The paper details sound practices in a pragmatic manner that affords market participants appropriate flexibility in meeting certain key objectives established by the regulators, rather than setting forth rigid requirements for all participants.



We urge the UK Government and regulators to work with key industry groups and the private sector to strengthen coordination, and recovery and resumption of business operations and systems that support market activity after a catastrophic event by:

- Identifying critical financial and general infrastructure institutions;
- Encouraging industry groups and organizations to establish a forum for their representatives to structure a robust and comprehensive cross-institutional incident planning and management program, which could also function as a primary contact and communication organization for the government, regulators, and the private sector when a catastrophic event occurs;
- Establishing appropriate guidelines for robust business continuity and disaster recovery solutions and plans that are consistent across the financial sector and recognize the need to plan for redundant systems and operations;
- Working with the relevant industry groups to establish “authorized parties” so that industry decisions can be made consistently across the financial sector if necessary; and where no such authority exists, exerting the necessary influence to ensure that appropriate collective consistent decisions are made by individual industry participants;
- Examining the need to coordinate actions taken across markets, including coordination with non-financial regulators of other industries where critical dependencies (and potential single points of failure) exist (e.g., telecommunications) and implement necessary guidelines to ensure a consistent approach;
- Establishing appropriate systems and procedures to enable the government and regulators to communicate among themselves and with the private sector during an operational disruption;
- Identifying regulatory requirements that regulated entities will most likely not be able to meet in times of crisis and to be prepared to relax those requirements for as long necessary;
- Ensuring the willingness of the government and the Bank of England to preserve financial system liquidity by providing significant monetary injections in the short term thereby preventing potential financial collapses and other longer-term damage.



### **Proposed Suspension and Direction Powers**

The consultation paper is seeking feedback on the usefulness and desirability of the two powers potentially being sought, the direction power and the suspension power. These powers would not be used solely in a financial crisis, but would only be used in extreme circumstances involving a catastrophic event and only with the support of the private sector. The examples given in Boxes 6.1 and 7.1, however, suggest a number of circumstances, which do appear to rise to a level of national crisis, and which we believe would be better addressed through cooperation between the private sector, the UK Government and regulators.

The closing of the formal markets in the United States following the attacks on September 11<sup>th</sup> were decisions made jointly by market participants and regulators, without the need for formal regulatory intervention. Rather than direct intervention, the role of the government and regulators in the United Kingdom should be to support and enable market participants to focus on resuming operations by relaxing regulatory constraints and mitigating liquidity disruptions in the markets.

### **Proposed Suspension of Legal Obligations**

We believe that mandating the suspension of legal obligations as contemplated in the consultation paper raises serious questions of principle, as well as potentially interfering with the orderly efforts of market participants to take the steps necessary to resume their activities. As suggested in the consultation paper, market participants might be more inclined to wait until the government provides such relief before resolving the issues they face, and the government may find itself compelled to invoke the suspension power because the inaction by market participants causes greater uncertainty. Rather than actively promoting market resumption efforts, such powers could create a contrary regulatory incentive distracting participants by creating a focus on liability mitigation or prevention. In addition, the possibility of such action may have the unintended effect of creating disincentives for participants to strengthen their own business continuity and disaster recovery plans and to participate in broader end-to-end industry contingency tests.

If the government is equipped to make decisions that absolve certain institutions of legal obligations at the outset of a crisis, rather than allowing market forces to address and resolve the challenges that arise, the result could be significant operational and economic dislocation. The exercise of the proposed powers by the government and regulators without a full understanding of the downstream consequences, or the ability to manage those consequences, could further complicate – rather than alleviate – a major operational disruption. We recommend that if the government learns of circumstances where relief from legal liabilities is deemed to be necessary and appropriate, such relief should be



granted later in the crisis management process based on a full appreciation of all the relevant facts and circumstances.

For instance if, instead of funding the temporary liquidity needs of a paying agent, the government instead suspends the paying agent's payment obligation, the downstream effects could multiply through the financial community. The suspension of the payment agent's payment obligation may discourage the paying agent from working with counterparties and regulators to resolve the problem, which would be counterproductive. Instead, by ensuring that the paying agent receives the liquidity necessary to meet payment obligations, the downstream effects of the problem are minimized.

### **Proposed Strengthening of Contingency Provisions in Contracts**

We believe that strengthening the contingency provisions in contracts and other legal instruments may not be as effective in managing a major disruption as is desired. It is impossible to predict the impact of a major operational disruption. Each event would be different and at the outset no one knows what the future holds or how best to react to the situation. Contractual provisions would necessarily have to be carefully tailored to specific narrowly defined events, and market participants would in any event be reluctant to agree to contract terms that attempt to anticipate all of the possible consequences of major disruptions and that commit one or more parties to take particular courses of action before the fact. Participants would not want to commit to an action that they may be unable to perform in a crisis situation.

Successful management of a market crisis means to ensure the safety and soundness of the financial system through the resumption of normal "business as usual" market operations as quickly as possible. The purpose of the "force majeure" legal principle, as it is sometimes incorporated in contractual provisions, is to allow organizations to suspend their obligations or to escape liability in certain circumstances. While this may be a desirable outcome for certain organizations, it does not constructively contribute to market resumption.

A more constructive approach is one in which the private sector, in close collaboration with the government and regulators, rapidly and diligently pursues decisions and actions that restore operational functionality and market participation through the provision of liquidity or other support needed. We believe that contractual contingency provisions would have limited utility and may be counterproductive in the case of a major operational disruption.

### **Business Continuity and Disaster Recovery**

We believe that the most effective way for the private sector to prepare for and respond to a major operational disruption is if all market participants evaluate and strengthen their individual company and inter company business continuity and disaster recovery plans.



The industry should focus on both individual company resumption capabilities and those capabilities for the market infrastructure and other service providers, such as telecommunication service providers and other critical dependencies.

The UK Government and regulators could provide valuable assistance by establishing guidelines that would apply to all segments of the financial markets private sector facilitate the evaluation of their business continuity plans and their strategic investment decisions to strengthen their recovery capabilities. Regulators could add value by rigorously assessing the contingency plans of the organizations they supervise, including an evaluation of the adequacy and frequency of testing.

The contingency plans of the core clearing and settlement organizations and firms that play a significant role in critical financial markets should be aligned by virtue of meeting the same objectives and criteria, although security, confidentiality and competitive issues may prevent the sharing of the plans themselves between institutions. Each institution could review its plan with the regulators who could assess all plans for consistency of approach.

Market utilities such as exchanges, clearing agencies and depositories should establish, maintain and publish to their members the policies and methods for resuming operations and/or ensuring continuous operations during a catastrophic event.

In addition, major market participants could establish a contingency protocol procedure that would enable them to settle on their respective books transactions caught “in transit” when a crisis begins. Establishing such an arrangement is only viable if regulators and the Bank of England also agreed in advance to meet any participant short-term liquidity needs with the necessary funding.

By aligning institutional recovery plans within a market infrastructure framework, under established regulatory guidelines, regulators will be in a position to focus on determining the type of regulatory relief required during a catastrophic event. They will also be able to identify quickly the key market organizations that may require funding support. One potential consequence of a crisis event, which can be anticipated, is an interruption in the flow of funds throughout the financial system. As long as the regulators and the Bank of England are prepared to act quickly and fund liquidity problems, a solvency crisis can be averted.

### **Market Cooperation**

Establishing appropriate systems and procedures to enable the government and regulators to communicate among themselves and with the private sector during times of operational disruption will facilitate and strengthen market cooperation.



Market cooperation during a catastrophic event is likely if close cross-industry cooperation has occurred in advance of the event through joint industry planning for contingency situations, and testing of contingency plans between organizations and market infrastructure participants on an end-to-end basis. The government can promote this kind of planning and coordination between industry participants by creating guidelines for the private sector to follow as a best practice.

The government also could act as a central repository for an accurate centralized database of emergency contact information on the senior management at key financial institutions. To the extent that current law prevents industry groups or the private sector from maintaining similar contact lists, the government may wish to consider whether exceptions may be appropriate for catastrophic planning purposes. The government could establish a cross-industry forum that would include representatives from the financial industry, regulators and the Bank of England to promulgate best practices for incident planning and management. This same forum could become the primary communications vehicle in the event of a crisis.

With appropriate planning, preparation and coordination, the government should have no need to resort to direction and suspension powers.

### **Conclusion about Proposed Use of Legislative Powers**

We do not believe that new legislation would be useful to help promote order in the financial system in the face of a major operational disruption. The establishment of such a power will discourage market participants from planning and taking appropriate actions prior to a catastrophic event to minimize the impact of such a situation. Operational and economic dislocation will be increased because inaction by market participants will be encouraged.

We believe that questions of principle are raised by a suspension of legal obligations, and that a suspension would interfere with the orderly efforts of affected market participants to take necessary and appropriate steps to resume their activities. For these reasons, we do not believe that the suspension and direction powers are the right choices to help promote order in the financial system in the face of a major operational disruption.

Rather, State Street believes that the initiatives described under the **Role of Government, Regulators and Central Banks** section above and detailed in the **Business Continuity and Disaster Recovery** and **Market Cooperation** sections in this document, will result in the desired outcome of quickly returning more orderly markets to normalcy during a catastrophic event. A sufficiently formalized industry body with decision-making authority can foster the kind of cooperation between the private sector, the UK Government and regulators that is needed to contain and manage a crisis when considering whether or not to close financial markets.



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The UK government, regulators and central banks should direct and support preparatory planning, communications facilitation, and market coordination activities in the private sector, formally, by establishing appropriate business contingency and disaster recovery guidelines, and informally, by working with key individual institutions and industry groups to ensure that financial markets are as robust in terms of contingency planning as possible should a catastrophic event occur. We encourage the UK Government and regulators to work towards the common objective of market resiliency.

If the government decides that the new legislative powers proposed must be adopted, they should be limited to a crisis event involving activities occurring within the United Kingdom. We do not believe that a non-UK financial institution's performance issues, resulting from a major operational disruption, should subject it to the direction or suspension powers of the UK Government even though some of the affected investors or transaction parties are located in the United Kingdom.

We thank Her Majesty's Treasury for their efforts and look forward to participating in the discussions on this important industry issue.

Sincerely,

Joseph W. Chow  
Executive Vice President

cc R.E. Logue  
State Street Corporation