

The Financial System and Major
Operational Disruption FSM Team
Room 4/16
HM Treasury
1 Horse Guards Road
London SW1A 2HG

April 25, 2003

Dear Sirs,

The Financial System and Major Operational Disruption

Morgan Stanley is pleased to respond to HM Treasury's consultation paper "The financial system and major operational disruption".

Executive Summary

The consultation paper raises complex issues; and the questions posed by HM Treasury indicate the extent of the difficulties of creating appropriate emergency powers for the UK financial authorities (HM Treasury, the Bank of England and the Financial Services Authority). We agree that it is not clear that the financial authorities currently possess all the necessary and appropriate powers for dealing with a significant disruption to the UK's financial markets. However, in the absence of a clear understanding of the current state of preparedness within the UK markets, we do not believe that reliable conclusions can be drawn now on whether the powers of suspension and direction proposed in the paper are necessary or appropriate.

We propose that HM Treasury establish a formal mechanism for co-ordination, bringing together representatives of the financial authorities, key market participants and crucial market infrastructure. In the absence of an emergency, this committee should function as a steering group for an examination of the current state of affairs, considering existing powers available to the financial authorities and current market standards and practices. Based on this examination, the committee should develop recommendations to address gaps identified, with a clear preference for market solutions (but not to the exclusion of additional or amended powers for the financial authorities if it is concluded these are needed). In an emergency, this committee will provide a focus for gathering and distributing intelligence and information and will provide a forum for ensuring that actions, whether market driven or regulatory, will be targeted and co-ordinated to achieve maximum benefit.

Introduction

HM Treasury's paper raises complex issues of law, contract, contingency planning, market standards and practice, and public policy. The UK's financial market is comprised of diverse markets, most of which are interconnected substantially with other markets around the globe. A major operational disruption in the UK financial markets will have implications for, and impact on, markets in other jurisdictions; and the implications and impact will differ across markets, market participants and market infrastructure, even within the UK.

General Observations

We agree that the primary responsibility for preparedness, contingency planning and recovery rest with the markets themselves: with market participants and market infrastructure.

The importance of the issues raised in the paper, for market resilience and prudent civil contingency planning, and the need to consider issues in the context of differing markets and market segments, make it imperative that HM Treasury, the Bank of England and FSA proceed on the basis of an informed understanding of the extent of both current market contingency planning and powers available to the financial authorities under existing legislation and regulation. Although the paper identifies many of the significant issues in the questions it poses, the cursory and general analytical treatment of the issues underscores the need for a more considered examination of the current situation.

The UK's financial markets comprise a range of markets (including equity, debt, derivative and commodity) and market participants (including banks, securities houses, exchanges, clearing and settlement providers and payment systems). A significant disruption will not impact all markets or market participants identically, a fact that will have implications for the development of appropriate market-approaches for dealing with disruption and for action by the financial authorities. Not all relationships in the UK's financial markets necessarily are covered by specific contracts; many transactions will occur in accordance with market rules and market practices.

We are concerned that the proposed approach, based on new powers of suspension and direction, (1) is not sufficiently calibrated to actual gaps in market preparedness and legislative/regulatory authority, (2) does not take appropriate account of the international dimension of the UK's markets, with obligations performed in one jurisdiction but subject to contracts governed by the laws of other jurisdictions, and (3) will lead to unintended and potentially significant consequences. A clear understanding of the current state of preparedness within the UK markets is a *sine qua non* for the consideration of possible legislative and regulatory action.

Pursuing the current proposals without further analysis and more careful preparation risks creating destabilising uncertainty in markets which require maximum certainty and which have deliberate allocations of risk. Furthermore, given the global interconnectedness of major financial markets, it is fundamental that any remedial action developed or implemented by the UK financial authorities in relation to a major operational disruption in the UK must be co-ordinated closely with authorities in other major financial centres and markets (in particular, the US).

Our Proposal

Market participants and market infrastructure must ensure that their contingency planning is sufficiently robust to enable them to discharge this responsibility efficiently and effectively, minimising the impact of a major operational disruption. Appropriate preparedness is a combination of (1) business continuity planning by each individual element of the UK's markets (participants, infrastructure and the authorities), (2) market standards and practice, including contractual provisions and rules of infrastructure providers (exchanges and clearing, settlement and payment systems), and (3) co-ordination to ensure that plans, practices and standards are compatible and sufficiently comprehensive. Co-ordination requires clear lines of communication and accurate intelligence about market conditions.

Accordingly, we propose that HM Treasury establish a formal mechanism for co-ordination, bringing together representatives of the financial authorities, key market participants and crucial market infrastructure. Given its knowledge of markets and payment systems, and its role as liquidity provider to the UK markets, we believe the Bank of England should chair the committee. This committee will have an important role in assessing the current state of preparedness and co-ordinating recovery efforts in the event of a major disruption.

Examination of Current Situation and Development of Recommendations

Initially, the committee should:

- Conduct an analysis of the powers currently possessed by the financial authorities which would be useful in responding to a major operational disruption;
- Supervise an analysis, undertaken by the private sector (which could be co-ordinated by the Financial Markets Law Committee), of current market practices and market standards to identify gaps which could have implications for the recovery of the UK markets. Sponsorship and co-ordination by the financial authorities will underpin this market-led examination and provide them with a greater understanding of the state and nature of preparedness;
- Based on the conclusions from the foregoing exercises, develop preliminary recommendations to address the gaps identified and enhance the resilience and preparedness of financial markets. These preliminary recommendations should prefer market solutions (including changes in practices and planning, the adoption of new standards, compatible assumptions, etc.) but, if necessary, should identify where existing powers should be amended or new powers introduced;
- Conduct a full consultation on its recommendations and develop a final proposal for addressing a major operational disruption;
- Co-ordinate the adoption and implementation of the final proposal by market participants, infrastructure and the financial authorities; and
- Consider the position in other major financial centres and markets (in particular, the US).

Ongoing Responsibilities

After the gap analysis has been completed, the committee will continue to have a non-emergency role. It should:

- Monitor developments in market structure, practices and standards to ensure that contingency planning remains appropriately targeted. This could be accomplished

through sponsorship of regular scenario exercises to test preparedness and identify areas of weakness; and

- Liaise, as appropriate, with authorities and responsible organisations in other major financial centres and markets.

Focus for Communication and Co-ordination in an Emergency

In the event of a major operational disruption, the committee should:

- Provide a focus for the collection and analysis of information about the situation in the UK markets (and other major financial markets), ensuring that the financial authorities have current and accurate intelligence about the markets. This will help identify particularly difficult areas requiring attention from market participants and regulators and enable the Bank of England to determine where liquidity may be needed;
- Ensure clear lines of communication (1) among the financial authorities, (2) among market participants, market infrastructure and the authorities, and (3) with authorities in other major financial centres and markets;
- Advise HM Government and other authorities on the need for, and specific nature of, any actions to be taken to address issues created by the disruption. A broad variety of issues may arise, including the need for (1) liquidity, (2) (temporary) relief from certain regulatory requirements, and (3) specific, targeted general infrastructure repair (electricity, telephone communications, water, etc.);
- Stand ready to facilitate the co-ordination of implementation of remedial actions by the UK markets (participants, infrastructure and the authorities); and
- Facilitate the co-ordination of necessary action with authorities and responsible organisations in other major financial centres and markets.

Other Issues

Liquidity may need to be provided in an emergency to relieve pressure in the markets and to facilitate their orderly operation in the aftermath of a significant disruption. The amounts may be substantial and the provision of collateral may not be possible, necessitating careful consideration of the Bank of England's ability to provide liquidity in such circumstances. HM Treasury would need to stand ready to underpin potentially un-collateralised liquidity injections by the Bank of England.

The paper explores two possible powers, suspension and direction, but does not consider other options. Several powers warrant consideration, including:

- The power to declare bank holidays or “non-business days”. Many contracts address issues of payments falling due on non-business days and the declaration of a bank holiday would have the desired effect of providing “breathing space” without actually interfering with private contract terms. We agree that the Banking and Financial Dealings Act 1971 is inadequate and that amendments should be made to enhance its utility and provide the authorities with a simple, non-invasive and effective option to address disruptions.
- The ability to suspend legal and regulatory requirements (as opposed to contractually assumed obligations). The paper considers a power to suspend legal obligations, but does not address what relief the authorities could grant through temporary suspension of regulatory requirements (such as exposure reporting and VaR obligations). It is widely believed that, in the aftermath of the September 11th attacks, the granting of relief by the

US Securities and Exchange Commission from restrictions on share buy-backs facilitated the re-opening of the US equity markets.

A brief review of approaches taken in other jurisdictions would provide a useful check to ensure that the approach of the UK markets and authorities is current. For example, Hong Kong would provide a helpful precedent in the way in which it deals with typhoon risks through declaration of “non-business days” and we believe this usefully could be analysed.

Our Responses to the “Key Broad Questions”

We have set out below our responses to the “key broad questions” identified in Box 1.1 of the paper, together with answers or references to other questions where we have comments and observations.

3a Do you have any general comments about types of market-based approaches to promoting order in the financial system during major operational disruption?

We agree that contingency planning (contractual provisions, business continuity plans, etc.) and co-operation are key elements in promoting order in the UK financial system. Communication and preparedness are equally important and will require appropriate co-ordination across markets, among market participants, and with the financial authorities. Accordingly, we have proposed the creation of a co-ordination mechanism in the form of a committee of representatives from the financial authorities, key market participants and crucial market infrastructure.

Two types of market-based approach are identified in the paper:

- contractual contingency planning, which includes specific contracts and formal market rules, and
- market co-operation.

The UK’s financial markets comprise a range of markets (including equity, debt, derivative and commodity) and market participants (including banks, securities houses, exchanges, clearing and settlement providers and payment systems). Moreover, the UK’s financial markets are an integral part of a complex web of global financial markets which have developed a highly-synchronised method of operations. A significant disruption will not impact all markets or market participants identically, a fact that will have implications for the development of appropriate market-approaches for dealing with disruption and for action by UK financial authorities. Not all relationships in the UK’s financial markets necessarily are covered by specific contracts; many transactions will occur in accordance with market rules and market practices.

In an emergency, actions should only be taken to address known problems. This will require an accurate and timely assessment of conditions in the market. Identification of pressure points will be essential, as will discussion and consideration of what steps should be taken to relieve pressures and facilitate recovery. Co-operation among market participants and between the markets and the financial authorities also will be needed to ensure that mitigating and corrective action is orchestrated to ensure that desired objectives are achieved. The committee we have proposed will provide a focus for intelligence collection and analysis and facilitate co-ordination among market participants and infrastructure of agreed remedial actions.

Co-operation among market participants is important before any such event occurs as well, in particular through the development of business continuity plans (for instance, to ensure that the underlying assumptions are compatible).

Change is an unchanging feature of financial markets: new products and services are introduced and new markets are created. Evolution and development, particularly of market infrastructure, challenge authorities and market participants to adapt and point to the need for on-going assessment of vulnerabilities in preparedness and contingency planning. Under our proposal, the committee would have an ongoing role monitoring developments to ensure that planning remains appropriately targeted.

3b Is there more that could usefully be done by the private sector to strengthen the contingency provisions in contracts and other legal instruments? Is there a role for the authorities in assisting with this?

We agree that the primary responsibility for recovery following a major operational disruption rests with the private sector; however, the financial authorities do have a role in providing assistance to, and facilitating action by, market participants and infrastructure. The financial markets are diverse and a disruption will not have a uniform impact on all markets or all market participants. Contingency planning will be most effective where it is co-ordinated, both in development and in planned implementation/invocation. The committee we propose will provide a means for co-ordinating actions by the markets themselves and by/with the authorities.

Contractual provisions, market practices and business continuity plans of market participants are components of contingency planning by market participants. The efficacy of this planning will be enhanced where approaches (1) provide the means to address specific disruption, (2) are compatible with approaches taken in other markets or by other participants, and (3) are co-ordinated.

A careful gap-analysis on the basis of scenario rehearsals should help identify areas of weakness in planning. The committee we propose also would provide an appropriate basis for discussion between market participants and the authorities on how best to address the issues identified. The financial authorities would have a natural role in facilitating co-ordination and encouraging the development and adoption across markets of standards and practices to enhance resilience and strengthen preparedness.

3c Is there more that could usefully be done by the private sector to strengthen market co-operation? Is there a role for the authorities in assisting with this?

Co-operation among market participants and between market participants and the financial authorities is essential both to prudent contingency planning and to the taking of appropriate action to address issues arising from a significant disruption. Scenario exercises sponsored by the committee may provide insights into business continuity planning within the markets, in particular whether current contingency planning assumptions and strategies are compatible.

4a In principle, would it be useful to have new legislation to help promote order in the financial system in the face of major operational disruption?

Maintaining order in the financial system in the face of a major operational disruption is important; however, we are not able to say whether new legislation is required to achieve this.

Introducing new legislation, in particular the far-reaching powers proposed in the paper, may have the undesirable effect of creating destabilising uncertainty in the UK markets. A market-based approach is preferable because (1) it ensures that resilience development and contingency planning remains focused in the markets, (2) provides the greatest flexibility, ensuring that planning is adapted to the changing forms and practices of markets, and (3) avoids the creation of a “moral hazard” by providing incentives to market participants and infrastructure to achieve appropriate preparedness as a matter of sound commercial management.

4b Have you any comments on: how new legislation might address risks; the possible disadvantages and limitations of new legislation; and the general constraints on the use of new legislation?

Whether new legislation is needed to address risks remains unclear. The examination of current standards, practices and powers we propose will facilitate this assessment. If the conclusion from this examination and analysis is that new powers are advisable or necessary, then these should be targeted to address the identified needs.

The paper does not seriously consider alternatives to the proposed powers of suspension and direction. Other powers should be considered, however, as should approaches adopted in other jurisdictions. The UK should strive to develop a “state of the art” approach to contingency planning and disaster recovery. Two powers that warrant further consideration are: (1) a sensible and effective power to declare bank holidays or “non-business days”, where the Hong Kong approach to addressing typhoon risk through declaration of non-business days may be useful, and (2) the power to suspend certain regulations and legal requirements. These should prove better suited to the international nature of markets by avoiding a narrow focus on UK law governed contracts and infrastructure.

New legislation may entail disadvantages and limitations. The proposed powers, if adopted, may have the unintended consequence of creating a “moral hazard”, encouraging the belief among market participants, infrastructure and investors that recovery from disruption will be addressed by the financial and other public authorities. Action by the financial authorities should reinforce the need to appropriate preparedness and, as the paper notes, emphasise that the markets themselves must take the lead in resilience development, contingency planning and recovery.

The proposed powers are limited to the UK, focused as they are on suspending legal obligations and directing infrastructure. Arguably, only UK law governed obligations and UK infrastructure will be susceptible to this approach. We consider this limitation in our response to 4c.

4c If new legislation were to be sought, are the suspension and direction powers the right choices? Are there any other types of legislation that might be useful to help promote order in the financial system?

We cannot conclude whether the proposed suspension and direction powers are the right choices, assuming that new legislation were to be sought. As we explain above, in the absence of a clear understanding of the current situation, with respect both to existing powers available to the financial authorities and to market practices and standards, it is not possible to reach reasonable conclusions about the advisability or necessity of new powers.

Generally, we believe both the suspension and direction powers are over-broad and doubt that, during a crisis, the financial authorities will be able to provide the calibration envisaged by the paper and necessary to minimise unintended consequences. The international nature of the UK's markets and the interlinkages with other markets around the globe will limit the efficacy of the proposed powers. Both proposed powers are limited to the UK, focused as they are on suspending legal obligations and directing infrastructure.

The proposed suspension power would be effective with respect to obligations governed by UK law. However, the effect on an obligation to be performed in the UK but governed by a law other than UK-law remains unclear. Given that a significant amount of business conducted in the UK markets is subject to contracts governed by non-UK law, we doubt that the proposed suspension power would have the desired effect of creating "breathing space". The direction power will have limited effect because many transactions will be cleared and settled outside the UK; for example, most OTC transactions use Euroclear or Clearstream, essentially situated outside the UK and operating across a multitude of national jurisdictions. It is doubtful at best that non-UK institutions would be susceptible to UK direction orders. The uneven effect of both the suspension and direction powers may create further confusion in the markets rather than achieving the desired result.

We have mentioned other types of legislation in our response to 4b. In particular, we believe further consideration should be given to (1) developing the ability to declare a bank holiday or "non-business day", where the Hong Kong approach may be useful, and (2) suspending certain regulations to minimise the negative impact of an event and facilitate recovery.

6l *Do you support the idea of a suspension power, subject to the constraints of paragraph 6.28?*

Without further information about the current state of market practice and standards and the powers possessed by the financial authorities, we are unable to commit to support a suspension power. We agree that paragraph 6.28 identifies a number of important considerations and factors which the financial authorities must bear in mind when contemplating *any* action.

7f *Do you support the idea of a direction power, subject to the constraints of paragraph 7.29?*

As with the suspension power, without a clear understanding of the specific need for such a power, we are not able to commit to support a direction power. Again, we agree that paragraph 7.29 identifies a number of important considerations and factors which the financial authorities must bear in mind when contemplating *any* action.

Yours faithfully

Keith Clark
International General Counsel