

Our ref: SD/jm

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

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Dear Sirs

The Financial System and Major Operational Disruption

I write on behalf of the Law Society's Company Law Committee in response to the Green Paper issued by the Treasury on improving the way the financial system works in the event of major operational disruption.

Given recent international events, we recognise the reasons for the action proposed by Government, including new statutory powers, to ensure continuity in the financial system in the event of major operational disruption. However, in principle, our preference would be for encouraging the private sector to take responsibility for promoting order in the financial system in that eventuality rather than intervention by the state in the operation of the markets. Our concern is that providing the Government with new powers of intervention may introduce an element of uncertainty into the markets as to the response that the Government will make to any particular circumstance. Hence new uncertainty may be created undermining the objective of the new powers proposed for the Civil Contingencies Bill. Our concern in relation to this issue centres on the fulfillment of financial and other transactions in line with deadlines forming part of larger corporate transactions. We believe that it would be better for specific provision to be added to the legal documentation attaching to such transactions to take account of the eventuality of a disruption to financial systems rather than the Government assessing the level of disruption in the event of, for example, a major terrorist attack and then determining the action to be taken to intervene in the markets. The increasing use of force majeure clauses in contracts suggests that the need for Government intervention is declining.

We also believe that any proposal must be considered in the light of action which may be taken by Governments and others outside the UK. The financial system is international in nature and any proposals must take this into account. Participants will want to be clear whether any measures will affect them and this may be difficult to establish, for example where a contract is not governed by English law but has some other UK connection. Also, even where a contract relates solely to the UK, there may be separate contracts with links outside the UK. Proposals which deal only with the UK contract may leave the party with a different economic position from that expected.

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

We believe that more can be done to encourage the adoption of contractual contingency planning. More can be done to encourage the use of standard clauses, either through trade associations or through the promulgation of standard wording. In that respect the UKLA could encourage the adoption of contractual contingency planning by listed companies and the FSA could encourage regulated entities to review their contingency plans.

Whilst the scope for market co-operation will always be limited by the belief of some participants that they must retain a competitive edge and this may discourage them sharing of precedents or standard clauses we believe that there is the potential for further action to encourage market co-operation. Again we see a significant role for trade associations and market regulators.

We also believe that there is a role for other public authorities to encourage private sector companies to respond to the threat of major operational disruption. Recently the FSA has warned financial service operators based in the City of London that all too few of them have provided for back-up facilities outside the range of any physical attack on the centre of London. The FSA has also issued new guidance to firms in the financial services sector on operational risk systems and controls. This covers people risk, IT systems and information security, business continuity management, and procedures to identify, assess, monitor and control operational risks. CRESTCo has publicised its arrangements for disruption to the CREST system. It has a secondary processing site which can be activated within an hour and which has been tested in practice recently when the main site was struck by lightning.

The Law Society in its capacity as an employer has recently been asked to undertake an emergency planning exercise to test its arrangements in the event of a terrorist attack and its recovery programme. Persistent warnings and pressure of this nature will eventually succeed in driving the message home that arrangements must be made by all companies, large and small, to provide for the eventuality of major operational disruption and to adopt recovery programmes.

Question 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?

A key feature of the events of 9/11 was the extent of market co-operation between operators in the financial services sector to overcome physical, transactional and contractual difficulties. However, more can be done to encourage the use of contingency provisions in contracts and other legal instruments by the private sector. As suggested above, we do see a role here for trade associations and other bodies linking operators in the financial services sector. We certainly believe that more could be done to produce appropriate model force majeure clauses for inclusion in contracts and their widespread promulgation.

Question 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?

The Green Paper refers to a joint Treasury, FSA, Bank of England standing committee on UK financial stability. That body must take the lead in co-ordinating

planning for an emergency and business recovery. It should take the lead in encouraging collaboration between market participants and between market participants, public authorities and the operators of financial infrastructure.

Question 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?

We think it would be useful to see if new legislative powers can be drafted in order to preserve order in the financial system in the event of major operational disruption.

Question 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?

As indicated in our opening comments, we do have concerns that any new powers for the Government to intervene in the operation of the financial system and markets could in fact introduce an element of uncertainty. We would, therefore, encourage those powers to be clearly circumscribed and, if at all practicable, the Government should indicate the precise type of situations in which those powers would be exercised. We would also recommend that the legislation should address the issue of the cost implications of any intervention in the markets by the Government. In our view that cost should adhere to the Government. Attention also needs to be given to the global nature of modern financial markets. The UK cannot act unilaterally without possible damage to UK interests. We would therefore like to see a requirement inserted into the Civil Contingencies Bill that, in the event of major operational disruption to the financial system, Ministers must have regard to the action adopted by other countries before exercising any new statutory powers provided by the Bill to intervene in UK markets.

Question 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?

In principle we would prefer power to suspend financial obligations rather than a power to intervene to direct the closure of financial system networks for however short a period. As corporate practitioners our concern is that the markets or payment systems might be closed in the immediate run up to the deadline for, for example, a share issue. The imposition of what would, in effect, be a Bank Holiday similar to that which occurred in the past (1931) could have significant implications. The stock markets, clearing settlement and payment systems are all in the private sector and we believe that they are capable of making provision for such an emergency, both in advance and in the event.

Question 5a - Have you any comments on the possible approaches to making secondary legislation/administrative directions, including who should exercise this function, the attractiveness of potential fall back routes for making the secondary legislation/administrative directions, accountability to Parliament and modification of secondary legislation/administrative directions?

Given the potential seriousness of the circumstances which might force the Government to exercise the proposed new statutory powers, it would seem necessary to provide for a Treasury Minister to make the secondary legislation or administrative direction. However, where ever practicable, we would prefer for such action to be taken through Parliament and, if that is not possible, then it should be affirmed by Parliament as soon as possible thereafter.

Question 5b - Should primary legislation include further conditions for use of its powers (beyond the basis for use being major operational disruption and not a purely financial crisis)? If so, what?

We would prefer the use of these powers to be circumscribed as far as possible and would certainly discourage the use of such powers beyond the instance of major operational disruption. If possible we would recommend the primary legislation to specifically exclude intervention in a purely financial crisis. To discourage misuse of these powers we would like to see a requirement for the appropriate Treasury Minister to consult the Governor of the Bank of England and the Chairman of the Financial Services Authority or their equivalent before such powers could be exercised in any other circumstance.

Question 5c - Would you support specification in the primary legislation of a maximum time period for the duration of powers? If so, how and for what period?

Obviously we would prefer such powers to be as limited as possible. However, in advance of the event, it is not possible to anticipate the extent and duration of any interruption to the operation of the financial system. It would not, therefore, perhaps be sensible to impose a limitation on any intervention in the market. However, we would suggest instead that the Treasury Minister making the secondary legislation or administrative direction should specify the duration of that action in terms of a number of days. If the emergency has not passed at the expiry of that date, then the Minister should be required to issue a further order or direction.

Question 5d - If the powers were adopted, do you agree they should affect actions in the UK (rather than actions governed by UK law)?

As a matter of principle we oppose UK legislation of an extra-territorial nature. We would therefore expect these powers to be confined to actions that take place in the UK. As explained above, as a practical matter we believe it is not desirable to consider the UK position in isolation from other jurisdictions.

Question 5e - If the Government seeks new legislation, should it allow the use of powers following major operational disruption affecting a non-UK major financial centre?

We see no reason why the Government should have powers to intervene in the markets and financial systems in the event of an operational disruption in a financial centre other than in the UK unless that event itself leads to operational disruption in the UK. Again, we would not wish to minimise the impact of 9/11 for the UK financial markets. However, in retrospect we see no justification for there to have been intervention by the Government in those circumstances nor in similar in the future.

Question 6a - Which wholesale market obligations should be included in a suspension power's maximum scope?

We suggest that the maximum scope of the suspension power should be limited to the obligations identified in the Green Paper, namely wholesale loans and deposits, high value wholesale payments, wholesale foreign exchange transactions, derivative contracts, securities and money market paper, transfer orders and the bullion market.

Question 6b - Should retail obligations be included in a suspension power's maximum scope?

As indicated in the Green Paper, most retail obligations are less time-sensitive and we do not, therefore, believe that the suspension power should include retail obligations.

Question 6c - If a distinction should be made between wholesale and retail obligations, how should the line be drawn?

The distinction should be based on the character of the parties, that is that both parties are financial institutions or major corporate bodies involved in the financial services sector.

Question 6d - Which insurance contracts, if any, should be included in a suspension power's maximum scope?

No comment.

Question 6e - Are there any other types of obligations suitable for inclusion in a suspension power's maximum scope?

No comment.

Question 6f - Should obligations governed by foreign law, but falling to be performed in the UK, be subject to the suspension power?

See the response to Question 4b above where we make the point that the Government should have regard to the action of other countries in the event of major disruption to financial markets. Clearly it would be invidious for the UK to act alone and thereby possibly penalise the overseas party to a contract. That could damage the UK as a centre for international trade and as the leading legal system for international business. Nonetheless, if the emergency envisaged prevents a party from fulfilling its obligations in the UK, even though those obligations are governed by foreign law, then the protection offered by the suspension power should be available equally to that party. Incurring a penalty through failure to meet an obligation which was occasioned by a market or system failure in the UK, or a suspension order, would be inequitable. That concern reinforces the view that the preferred course would be for the market itself to address the issue through the adoption of appropriate contractual provisions.

Question 6g - Should a suspension order only be able to apply to all the obligations arising from a contract?

The suspension order should apply only to obligations arising from a contract which cannot now be fulfilled as a result of the imposition of a suspension order by the Government.

Question 6h - Should a suspension power only be able to affect obligations which could not be fulfilled as a result of the disruption?

Yes.

Question 6i - Are there any other restrictions that should apply to how a suspension power could be used?

No comment.

Question 6j - Have you any comments about consequential effects of a suspension power?

No comment.

Question 6k - After a suspension period should obligations return immediately, as soon as practically possible or is some other approach preferable?

Ideally obligations should resume as soon as a suspension period ends. However, we accept that there may be circumstances in which it may be necessary to specify a subsequent date, for example, suspension period ending at close of business on a Friday afternoon and obligations resuming first thing on Monday morning, allowing market systems and participants to recover over the weekend.

Question 6l - Do you support the idea of a suspension power, subject to the constraints outlined in the Green Paper?

We support the proposal to circumscribe the circumstances in which the Government will be able to exercise any suspension power.

Question 7a - Should recognised bodies be within the maximum scope of a direction power?

Yes.

Question 7b - Should payment systems be within the maximum scope of the direction power?

Yes.

Question 7c - Should functions of institutions that are similar to the functions of recognised bodies and payment systems be within the maximum scope of a direction power?

Yes, but we envisage difficulties in defining the same. In particular, if the legislation is to define the maximum scope of the direction power, it must be clear who will be affected by that power so that companies and operators of financial systems can establish whether or not they are covered by the definition and can plan accordingly.

Question 7d - What actions should directions to infrastructure be able to order? Should directions themselves effect changes where appropriate or only be able to require infrastructure to take actions?

We would suggest that directions should specify the closure of a financial infrastructure and indicate a point in time when it would re-open. We do not consider it appropriate for the Government to use a direction order to impose rule changes or other actions which would normally be the province of other bodies.

Question 7e - Have you any comments about consequential affects of a direction power?

A direction order should provide a breathing space during which the authorities should be able to assess any significant consequential effects and, where necessary, to take statutory action to address, for example, legal and financial consequences.

Question 7f - Do you support the idea of a direction power, subject to the constraints outlined in the Green Paper?

Yes.

Yours sincerely,

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