

2. May 2003

Her Majesty's Treasury
The Financial System and Major Operational Disruption
FSM team
Room 4/16
1 Horse Guards Road
London SW1A 2HQ
Great Britain

Dear Sirs:

The Financial System and Major Operational Disruption

The Bond Market Association¹ welcomes the opportunity to comment on HM Treasury's consultation paper on the financial system and major operational disruption.

Executive summary

In general, the Association favors market-based approaches to governmental mandates in coping with financial disruptions. In this regard, we would encourage the development of one or more private sector committees that could take the lead in the case of a significant disruption in coordinating communications among key market participants and making any useful recommendations in terms of early closings, extended settlements, or other recommended trading practices.

Consideration of governmental mandates should be reserved for catastrophic events that prevent market participants in general from being able to execute and settle transactions on an orderly basis. Also, particularly given the increasingly international nature of fixed income and derivative markets, it is critical that further review of whether legislative authority is warranted take account of the need in an emergency for international coordination of actions by various national authorities. In our view, it is unlikely that the many complex issues that need to be explored in considering the need for new authority can be evaluated within the period prescribed by the consultation paper. We do recognise that time is of the essence, and we stand ready to assist policy makers in resolving these issues and in bringing legal clarity to the questions raised by this consultation paper.

General Approach

On the whole, the Association favors market-based approaches, in consultation with appropriate governmental authorities, to governmental mandates in dealing with potential financial disruptions.

The Association played an active role in assisting firms and the market to respond to the consequences of the attacks on 11. September 2001. The Association, after extensive discussions

¹ The Bond Market Association is an international trade association representing securities firms and banks that underwrite, distribute and trade in fixed income securities, in Europe and the United States, as well as internationally. More information about the Association is available on its website, www.bondmarkets.com. This letter has been prepared in coordination with members of the BMA European Legal Advisory Committee as well as members active from several of the Association's US-based committees.

with market participants and regulators, issued a series of recommendations on trading hours and settlement cycles in the aftermath of the attacks. Although these were not binding on our members, they facilitated a more orderly response to the disruption resulting from the attacks. In addition, the Association provided facilities to co-ordinate communications among members and between members and regulators and government officials.²

As a result of our experiences in the aftermath of 11. September, the Association has reviewed, enhanced, and streamlined its internal procedures for dealing with future potential operational disruptions. These changes include better defining the circumstances that will trigger the implementation of emergency procedures, prescheduling specific conference calls of key industry representations and Association staff on days on which an emergency is declared, and disseminating in advance telephone access information and other instructions that individuals with responsibilities that lie within each of the Association's divisions (government and agency, corporate bonds, funding, municipal bonds, and mortgage and asset-backed securities) can use. Such procedures contemplate close consultation with and participation by interested governmental authorities, as was the case following 11. September.

A primary advantage to private-sector initiated mechanisms of the type that the Association has employed for assessing and responding to financial disruption is that it allows those individuals who are most directly connected to the situation to take responsive measures. Another significant advantage is that it permits individual market participants the flexibility to respond to the disruption in a way that is most appropriate to their businesses, based on a collective sharing of up-to-date information. It is important to note that the Association's recommendations post 11. September (like early close recommendations that it issues in advance of national holidays) are not binding, or meant to be so, on any firm. Instead, these recommendations provide an important signal to the marketplace as to the collective sense of industry firms as to the anticipated liquidity that will be available to support trading on a given day.

Further, a market-based approach maintains for all firms strong incentives to invest in the systems and employees, and prepare the contingency plans, that will enable them to continue to operate under a wide range of conditions. Specific governmental intervention authority may have the unintended consequence of creating a "moral hazard" because of the perception by firms that they will not have any relative advantage in being able to maintain operations even if other firms are disabled. Therefore, we would encourage the development of one or more private sector committees that could take the lead in the case of a significant disruption in coordinating communications among key market participants and making any useful recommendations in terms of early closings, extended settlements, or other recommended practices. The Association would be pleased to assist in the development of committees of this kind. For example, our London Market Primary Dealers Committee already plays a significant role in the co-ordination of practices in the dollar denominated fixed income markets in London.

Timetable and process

Particularly given the increasingly international nature of fixed income and derivative markets, it is critical that further review of whether legislative authority is warranted take account of the need in an emergency for international coordination of actions by various national authorities. The consultation paper raises complex issues which cannot readily be evaluated within the period for consultation. We believe that it is still too early to comment in

² For a summary of the Association's activities in the aftermath of 11. September, see testimony of Micah Green, President of the Association, before the US House of Representatives on 12. February 2003 available on www.bondmarkets.com A detailed account of emergency meetings and actions taken by the Association following the attacks of 11. September is available on the Association's Web site at www.bondmarkets.com/market/9-11_minutes.shtml.

any detail on the proposals. We do not rule out the possibility that new legislative powers might be desirable. However, the case is not yet made.

It is essential that any proposals fully take account of the international nature of London's markets which form part of global markets, especially in the fixed income sector. This means that any effort to resume business after a major disruption is likely to involve authorities and market participants in several countries. In this respect, it is important that there is some degree of international consensus on how to approach these issues and the UK could clearly play a role in leading the development of thinking on this subject.

However, there is a risk that, if the UK were to press ahead to take new legislative powers, without the preparatory work at the international level to develop a consensus, this might in fact trigger other states to take parallel but inconsistent approaches to addressing these issues in a way which is unhelpful and fragmented. Even if other governments were to follow the UK legislative model proposed, that model may not be well adapted to local requirements or may, in a crisis, be exercised in a way which is less sensitive to market requirements.

We also believe that it is essential that any proposals are based on a proper understanding of the nature and extent of existing powers in other countries. The consultation paper mentions some of these in passing but without detailed discussion or analysis. It would be helpful to examine the approaches taken in other countries more fully to identify what, if any, lessons can be drawn from their experience. For example, the US experience of 11. September suggests that it might be useful to explore whether it would be helpful for government or regulators to have powers to suspend the operation of particular legal requirements. Following the attacks, the SEC used its emergency powers to relax rules on, among other things, the repurchase of own shares and the calculation of regulatory capital requirements for broker-dealers.³ The Association would be pleased to participate in any project aimed at gathering information internationally on these issues.

There are also other areas that would benefit from further study. For example, the events of 11. September indicate that a likely consequence of major operational disruptions will be a need to move management or other functions or personnel from one jurisdiction to another (firms in the US responded to 11. September by transferring some functions to the UK). However, there are regulatory and tax rules that could make it difficult to do this. We consider that it would be desirable to explore what, if anything, could be done to provide legal mechanisms that would facilitate this response where appropriate.

We also believe that it would significantly aid progress for there to be a much fuller analysis of, and shared understanding of the extent and likely effectiveness of, the powers that already exist in the UK for dealing with a contingency. The consultation paper does discuss the powers under the Banking and Financial Dealings Act 1971. However, it does not discuss, in any detail, the government's general powers under other emergency legislation, the powers of the Financial Services Authority (FSA) or other regulators or the powers of the operators of the exchanges, payment, clearing and settlement systems or other components of the financial infrastructure.

In particular, it is difficult for market participants to form any view, at this stage, on the proposed direction power without knowing the views of the operators of the major components of the financial infrastructure as to the issues that they believe that they would face in responding to a contingency. Market participants would also need to understand whether those operators consider that the power of direction would be of assistance and, if so, why any concerns cannot be adequately addressed by changes to their own rules or other aspects of the legal framework.

³ See SEC press release of 14. September 2001 available at www.sec.gov/news/press/2001-91.txt

Similarly, we believe that it would aid market participants' understanding of whether there is a need for the proposed suspension power if there were broader dissemination of the different approaches already adopted in the private sector to address the legal consequences of operational disruption. There is a variety of approaches to these issues in contracts. In some cases, there may be *force majeure* clauses that allow postponement or termination of obligations where a person is prevented or hindered from performing its obligations by some event outside its control, although in the past there has been some reluctance to include these in financial contracts. Nevertheless, financial contracts often address these issues through business day provisions (which postpone obligations when the day for performance is not a business day) or through other provisions such as settlement, market or other disruption clauses which address particular issues in a way appropriate for the contract in question. A more generalised understanding of the issues raised by these provisions is likely to help market participants in reaching a view on whether private sector solutions might be a better way forward than a generalised power.

We are concerned that the using the proposed Civil Contingencies Bill as the vehicle for any legislative change would unduly limit the opportunity for the further evaluation and discussion that we believe is required. We understand that using that Bill would mean that the Government would move rapidly from the high level outline in the consultation paper to a draft bill in July, followed by final legislation soon thereafter. We are somewhat concerned that the issues raised can be adequately resolved within this timetable.

Suspension power

As a general matter, the invocation of a governmental suspension power raises many difficult legal and practical issues and may undermine rather than promote certainty in financial transactions.

As a general matter, the Association believes that the primary focus should be on preparing to keep the markets open in times of emergency.⁴ This is especially important for the over-the-counter (OTC) bond market. Participants should be permitted, if they are able, to trade to provide the necessary liquidity to the markets. While the proposed power would allow a party to perform its obligations, if it so chooses, the fact that market participants could, if the powers is exercised, choose not to perform their contractual obligations is, in our view, likely to cause as much uncertainty as it resolves. The ability of some participants not to perform (even if they are free to do otherwise) when they might in fact be able to do so will raise particular concerns in markets, such as the bond market, where the parties contract for strict performance.

Introducing such a power would also be out of line with other countries, such as the US. While the US regulators do have powers to suspend trading, this is narrowly circumscribed and does not apply to the over-the-counter decentralised markets in government, agency and municipal bonds. In addition, the OTC bond markets are among the most international of the markets with which UK market participants are involved. The consultation paper acknowledges, rightly, that it would be necessary to limit the effect of this power, in practice, to obligations that fall to be performed in the UK. However, this raises a number of concerns, such as:

⁴ For a more detailed discussion of a similar issue, see the Association's comment letter dated 17. March 2003 responding to the proposal by the Municipal Securities Rulemaking Board to adopt new powers to impose a trading halt in times of emergency available on the Association's website at www.bondmarkets.com/regulatory/sec_comment_letter_on_market_closings.pdf.

- A large part of the business in London is transacted under contracts not governed by English law. It is unclear whether foreign courts would recognise the effects of an exercise of the suspension power in relation to contracts governed by a foreign law even if they fell to be performed in the UK. Even if those courts recognised that it relieved a party from an obligation to perform, they may disregard any consequences prescribed by the UK law (e.g. as to compensatory interest).
- In many cases, it will be unclear where a contract is to be performed or a contract will involve performance of a package of obligations, some within and some outside the UK. For example, euro payments may be made either within or outside the UK depending on the precise contractual terms which may be difficult to ascertain quickly. Delivery may take place in one country and the countervailing payment in another. In these cases, the exercise of the power will not provide any real certainty and, indeed, may increase uncertainty as to what the impact of the exercise will be.
- Even if it is clear that the contract in question is to be performed in the UK, the contractual exposure may be hedged or offset by a contract which falls to be performed outside the UK. This is particularly likely in relation to bond contracts where the settlement may occur the settlement systems which are largely, but not exclusively outside the UK, or across custody accounts with custodians. Again, the exercise of the suspension power seems likely to lead to more uncertainty.

In fact, it may be only a minority of contracts in the bond markets that would be directly subject to the suspension. That itself seems likely to mean that the exercise of the power would not provide significant assistance by way of a breathing space, but instead would exacerbate any problem that already existed by creating additional uncertainty about which contracts were or were not affected.

Clearly, if the suspension power is to affect financial contracts, it must specify the consequences for the contractual parties. Market participants are likely to consider it unduly tilting the balance of negotiating power if a party was to be temporarily relieved of its obligations, without any obligation to make compensation and without any corresponding right on the part of the other party to withhold its own performance. However, it is not that easy to specify in an abstract way what is the appropriate arrangement for each different type of contract. This suggests that it is better to encourage the private sector to address this, where necessary.

In particular, in the sort of crisis that would generate a major operational disruption, it seems to us that it would be hard, in any timely way, to produce carefully tailored orders which addressed all the nuances of a particular market, let alone the wide variety of markets likely to be affected by operational disruption of the type being considered.

We also consider that it would be worth exploring other possible ways of addressing the issues raised. For example, the consultation paper does not discuss the possibility of making it easier to declare bank holidays under the 1971 Act in an emergency. While the paper does discuss the limited legal effect that declaring a bank holiday has on contractual obligations, the declaration might have a signalling effect which may be helpful. For example, if the declaration of a bank holiday has the practical result that in fact banks are shut this may have consequential effects in contracts through the business day provisions in contracts, without some of the adverse consequences of an exercise of the suspension power.

Direction power

Any invocation of authority of the type described would need to be carefully circumscribed and take into account the existence of multi-national clearance and settlement arrangements.

We have already indicated our concern better to understand the likely real need for the direction power. However, it should be understood that, for the bond markets, the majority of transactions take place in OTC markets and are cleared and settled outside the UK, for example in Euroclear and Clearstream.

Nevertheless, we are concerned about the possible effects of such a power. In particular, our initial reaction is that any power should be narrow in scope, covering only core institutions which are central to the financial system. For example, it seems to us that it is inappropriate to include multilateral trading facilities/alternative trading systems within its scope as these are unlikely to have any such role. The power should be restricted to recognised institutions and payment systems (perhaps those protected by the settlement finality directive).

We are also concerned that, in practice, the exercise of a direction power may amount to a direction to the users of the institution, by imposing rule changes on the institutions which would impose new obligations on users. This, in fact, makes it more difficult for market participants to predict the likely outcome of a crisis and may impair, rather than improve, their ability to plan for a crisis.

It also seems likely that it would be difficult for government, in a crisis, to be confident that the exercise of the power would be appropriate and would not itself add to the disruption. For example, while it may be desirable for a settlement system to declare a "time-out" to resolve settlement fails, the system operator is best placed to identify what is needed.

Again, this argues in favour of measures to ensure that the operators of the infrastructure themselves are able to take the necessary decisions to respond to a crisis.

Conclusion

As you will have understood, we favour the use of private sector initiatives to address these issues, wherever possible. We would be pleased to consider participation in initiatives or projects to explore the issues raised in the HM Treasury paper and how they could best be addressed by private sector action. We consider that a very strong case must be shown for legislative intervention, even that of the kind outlined in the HM Treasury paper. No such case has yet been made.

We hope that this paper is helpful. Please feel free to contact either me (+44.20.77 43 93 33) or John Ramsay (+1.646.637 9200) if you have any questions or comments.

Yours sincerely,

/s/

Scott-Christopher Rankin
Executive Director, BMA European Office

cc: Dan Lambeth, *Financial Stability and Markets* - HM Treasury