A. Introduction and Summary

1. We welcome this approach to a number of the difficult issues raised by the financial crisis and recent market events. As the HMT paper recognises, the issues are complex, inter-related and require a combination of actions by market participants, market infrastructures and the authorities to develop solutions. We expect to continue to work with the Government and our members in this area.

2. Our members would like to understand particularly how proposals in this consultation would interact with the requirements under the Banking Act 2009, as many firms have a group structure consisting of legal entities with a deposit taker authorisation, which are subject to the Banking Act 2009, and also conduct investment banking activities under another Part IV permission. Streamlining similar requirements of entities in a same group holding different permissions might help, especially if the firm acts as custodian.

3. We also note the importance of international co-ordination in relation to the development of proposals designed to ensure the orderly wind-down of internationally active investment banks. The scope of contingency plans, business information packs and continuity of service obligations should be clear. For such information to be useful, we expect that HMT and the FSA would look for information beyond a single legal entity in the UK, to include its parent and group in another jurisdiction for example. Because legal entities do not operate on a standalone basis in global firms, producing a report for a wider group would present practical challenges for reasons including the dynamic nature of business and organisations in which house business is carried on. Further clarification of the application of such requirement to non-EEA London branches will be helpful. As ever, international co-operation produces challenges and opportunities.

4. This paper considers the issues from the perspective of steps to be taken in relation to (i) normal market operations, (ii) an insolvency event and (iii) the consequences of an insolvency event.

A table relating our proposals to the questions raised in HMT’s paper is annexed. We also give additional detail and colour in the annex.

5. We all need to be mindful of the additional cost arising from enhanced requirements under new regulation, which will ultimately lead to greater cost for clients and may impact the commercial appeal of existing contracts and pricing. There is always a risk that additional regulation may increase the cost to clients (if regulation increases operational cost).

B. Normal Market Operations
6. The chief measures designed to protect against investment bank insolvency remain (i) the applicable rules and (ii) the monitoring and enforcement of rules, including capital adequacy rules. We support the moves in the paper towards greater clarity in two areas; first, in relation to the terms of the contractual relationship between firms and their customers (though we think that the contractual principles that govern transactions between a bank and its clients are generally clear) and secondly the area of investor education. Turning to the actions which need to be taken by firms themselves, we can identify these areas in which improvements are needed; first, in relation to accurate, timely record-keeping; secondly, in relation to the proposal that firms should plan for their own demise, making the necessary information available to the authorities in a timely manner and with arrangements for this information to be kept up to date. Firms should also make plans to make people and systems available after an insolvency event to support the work of, inter alia, insolvency practitioners and the Financial Services Compensation Scheme. We note that there are lessons to be learned in this area from the insolvency of Lehman Brothers in the UK. It may be necessary to change insolvency law in a number of areas and we discuss this further under section C ‘Insolvency Event’ below.

7. We focus on two areas in which further joint action by the authorities and market infrastructures should be undertaken:

(a) the need for clear and consistent contracts and rules [such as the proposed ‘OTC protocol’ for cash equity trades between dealers] , and the need for these rules to be operated fairly; and

(b) the need for regular exercises, rehearsing the actions to be taken in the event of a major insolvency. It is important that the lessons from recent events are properly learned and that people at all levels of the market infrastructure have planned and practised in advance. For some such exercises, it may be valuable to involve market participants and this should be arranged on a voluntary basis.

8. We consider issues highlighted in the consultation relating to rehypothecation or the chain of use of assets are a matter of commercial agreement of terms between a firm and a customer. We agree that clarity as to the risk factors arising from such agreements are important to avoid any misunderstanding, especially on the client side.

C. Insolvency Event

9. We turn now to the insolvency event itself. In the Lehman case, timing was clearly significant. Further thought should be given to the interaction of the rules about trading while insolvent and the need for trades which have recently been entered into to proceed to settlement in the normal manner. This is particularly important in respect of a highly interconnected firm with a large number of cash market trades to be settled.

10. A key ingredient is the provision of adequate numbers of appropriately qualified and motivated people from the insolvency practitioner’s firm and from the insolvent firm itself. The pre-insolvency steps we recommend should assist here, as will the discipline of “planning for one’s own demise”. It remains desirable that firms which are not yet insolvent, but are at risk of becoming so, take the necessary advice, in
confidence, so that planning for the insolvency event in detail can begin in earnest – in advance.

11. We acknowledge that difficulties arise in relation to the question of limitation of liability by insolvency practitioners. In most circumstances, this is a valuable safeguard; but we question whether, when assets and liabilities amount to a very much larger amount that can credibly be provided by an individual or a group of individuals, the addition of personal liability contributes to a successful outcome, or to public confidence in the insolvency process. We think the balance of advantage lies in limiting liability, since the costs associated with personal liability – particularly in relation to slowing down the insolvency process – outweigh the potential benefits of the ability to claim. Clearly, such arrangements must extend to responsible officers appointed in connection with the winding up of a UK branch and UK representatives of the insolvency practitioners appointed to deal with the insolvency of an overseas bank.

12. Speed of access is essential. This relates to both early and quick access by the insolvency practitioners and their staff and to the need for clients to be given ready access to assets held by the investment firm. Identified, unencumbered assets should be returned to clients as quickly as practicable and the insolvency practitioner should work closely and co-operatively with clients and their representatives to achieve this. In addition to unencumbered assets, the majority if not all custody assets held for prime brokerage customers are likely to be encumbered to secure financing or other exposure extended by the firm to the customer and so it is vital that encumbered assets that are not required to secure exposure to the insolvent firm are returned to clients quickly.

13. One possibility to assist in facilitating the return of assets is for consideration to be given to the creation of the role of “Client Assets Officer” establishing balances in client accounts for both cash and securities, paying out a substantial proportion of these balances quickly – where there is no dispute over title to the assets – and establishing an efficient and thorough process for completing the task of returning client money and assets held at the firm. The Client Assets Officer’s task will be considerably assisted by the maintenance of accurate records (both at the insolvent firm and at its suppliers and market infrastructures) and by the availability of systems and staff to enable early completion of this vital task. It will be important to develop effective proposals describing how the administrator and the Client Assets Officer work together, if this alternative is pursued. A number of LIBA members feel this proposal needs further debate; consideration might also be given to the imposition of a priority duty upon the insolvency practitioner to effect a quick and efficient return of client assets, though this may conflict with the duty owed to creditors of the insolvent estate.

D. After the Insolvency Event

14. In addition to the work of the proposed Client Assets Officer described above, market infrastructure involvement remains essential. Regular reporting by the insolvency practitioner will help maintain the confidence of clients and creditors and may assist in reducing the spread of repercussions. In addition, it will be important that the insolvency practitioner should not feel obliged to try and make new law in the Courts, because of the risk of delay that such litigation inevitably brings.
List of questions in
‘Developing effective resolution arrangements for investment banks’
Cross-references and LIBA’s answers

The Government would welcome views on the following questions. Our views are in italics

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?

We think these are the right principles.

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?

Please see paragraphs 6 to 8, 12 and 13 above.

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 VII of the Companies Act or otherwise to ensure the protocol is effective?

We prefer a market-led approach. We think there are circumstances in which Part VII support could be valuable; and we note that London’s importance as a financial centre means that HMT should also consider work with its European and international partners to seek to ensure equivalent outcomes. We also think that Euroclear UK and Ireland Rule 13 should have force of law in order to ensure contractual certainty.

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?

The principal sources of legal certainty are statute law, well-drafted regulatory rules (including the rules and practices of market infrastructure providers) and the intelligent, prompt exercise of discretion – where permitted or required under applicable rules. In addition, developing additional legal arrangements in the market may help; the proposed ‘OTC protocol’ for cash equity trades not subject to other contractual terms, is one example of this.

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?

We think the experience of the OTC derivative markets holds valuable lessons in this regard and we continue to work on applying these lessons to the OTC cash markets. Please see paragraphs 6 to 8, 12 and 13 above.

HMT could consider extending the protection of Part VII of the Companies Act to trades executed on FSA approved multilateral trading facilities and trades reported to MarkitBOAT or other UK established trade reporting venues (and requiring MarkitBOAT and MTFs to have a default regime, subject to agreement with our European partners in the case of the MTFs). We understand
MarkitBOAT is supportive of adoption of a default protocol, discussed in their response to HMT’s discussion paper. Widespread adoption of such a protocol might be preferable to a ‘patchwork’ of default regimes developed by the individual venues.

We would be supportive of an amendment of the Insolvency Rules 1986 to require an administrator to delete transfer orders pertaining to the outstanding settlement instructions in the event of the administration of a large financial institution.

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?

Any changes must not compromise the collateral taken by a Crest settlement bank in the event of the collapse of a counterparty. Any changes designed to alter the behaviour of prime brokers should not unwittingly limit or make more costly the activities of ordinary custodian banks – and vice versa.

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?

In addition to work on the areas of uncertainty uncovered by recent events, the principal tool is investor education, to complement the other initiatives. It is not clear to us that any other actions are required, beyond those identified in the discussion paper and our response.

We have seen the FMLC’s response and would draw HMT’s attention to Section 2 of that paper, responding to Question 7.

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?

We think that there is room for drafting improvement in client money rules, which would help clients better to understand their positions. Examples include: the treatment of cash as client money when it is transferred to a third party; the client’s contractual relationship with the firm; on a pooling event and risk of potential short falls; and how netting may affect the client’s entitlement.

Clear guidelines regarding ownership/actions on insolvency on the legal categorisation of client assets in a report to the Supervisor will help increasing certainty in the market.

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?

Please see our proposal for a ‘client assets officer’ in paragraph 13 above.

We think it is more effective to address this issue by improving the transparency of client holdings. This would allow clients to lay down ground rules for asset re-use by their agent depending on their policy and risk appetite.

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?
Close and continued consultation with the industry, working through relevant trade associations and in close touch with firms’ supervisors is the main tool.

We prefer the authorities to use outcome focused high-level principles as far as possible rather than prescriptive rules to achieve this objective.

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?

Para 3.53 of the HMT Discussion Paper suggests more risk warnings for clients on client/asset money protection. Risk warnings were introduced by MiFID for certain products and have greatly increased information given to clients. Most brokers have found that clients do not welcome the additional information and it should be carefully considered whether this is beneficial for custodians or which clients will benefit (institutional clients are generally able to make their own assessment). Targeted, specific disclosure is more likely to be helpful than generic, standard material.

Para 3.65 on affiliates may undermine the business of many global custodians and has far-reaching effects. It may also mean that custodians with good credit ratings may have to limit their activities (and turn away clients) which would force clients to then deal with custodial groups/entities with worse credit ratings which would clearly not be in the client’s interest. Alternatively, a custodian may be forced to use a sub-custodian outside the group with worse credit ratings and systems/controls at greater cost and risk which will not benefit the client. Daily/periodic reporting will not reduce this risk—surely the custodian should keep a list of sub-custodians and client can make its own assessment on credit/insolvency risk for independent jurisdictions.

Paragraph 3.70 suggests set-off rights that do not compromise customer asset protections—but the suggestion is uncertain here. Many banks will have cross-default rights across custody and investment banking operations which affect the credit risk and pricing of business they provide. Clients are free to negotiate on set-off rights and this affects pricing. Removing such rights may increase client collateral requirements and their ability to keep assets in custody (subject to security rights) rather than being transferred to derivative counterparties.

Chapter 4 – Achieving Effective Resolution

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

The FSA in its recent Discussion Paper (09/02) acknowledges that legal entities do not operate on a standalone basis in global firms. Such large groups are managed, as discussed in section 1.39 of the HMT paper, on a global basis, with group wide systems and processes. It is therefore not necessarily easy to operate firm-level failure management on a standalone entity basis. Such proposals, if implemented in an extreme fashion, could reduce the efficiencies of global financial firms and the benefits this efficiency brings to consumers and the financial system. They could also impact the status of London as a financial centre.

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

Business continuity and contingency arrangements for large groups are predicated on use of global arrangements. The potential cost and difficulty of ensuring contingency and continuity arrangements at the standalone firm level should not be under estimated.

Question 14: What other factors should be considered with regard to contingency and
continuity planning?
In paragraph 7 (b) above we recommend regular exercises by the authorities to test their people and systems, with involvement by market participants on a voluntary basis.

Issues relating to the implications for branches, which do not have separate legal personality, and the way in which collateral is managed for example, should be carefully considered.

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

We consider that the requirements for business information packs would be better targeted to larger, systemically important investment banks from the financial stability and systemic risk perspective. We are, however, aware that the process of keeping an information pack up-to-date will be practically very demanding, since as soon as it is updated, it will become outdated as a result of changes in different parts of a group. It is therefore a matter of striking the right balance between the needs of normal operations and the need to keep planning documents up to date “just in case”. Some members think that annual review of such information packs, rather than more frequent reviews, would be practical; others feel that if the pack is to be useful, it must be reliable. The information packs may be a better option than contingency plans.

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

Avoiding failure is as important as preparing for failure. Early supervisory intervention by the authorities for the purposes of managing micro-prudential risk, based on clearly articulated regulatory objectives, as well as managing the failure itself, must be considered. We agree with the point in paragraph 4.30 of the HMT paper that more “intensified engagement” with a firm in the run up to the filing for administration is essential.

Moreover, a global firm has a complex inter-connected structure of staff, operations, contracts for physical resource and banking and so on. We support initiatives for global resolutions, as effective preparation for cross-border firms could not be achieved without coordination of different regulators and harmonisation of legal frameworks. This would involve insolvency practitioners in working together to allow entities in global firms (in the case of insolvency of the parent) to continue to provide long-enough intra company support for an orderly wind down.

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?

Once an investment bank has failed, clarity, authority and speed need to be balanced.

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

We think an orderly insolvency process exists in law. The challenge is to make it work in practice; please see paragraphs 9 to 14 of our response. The measures we think are necessary include: early pre-insolvency engagement by regulators and the Bank of England; the proposal for a client assets officer; business information packs; and increased transparency.

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

Continuity of service obligations should be limited to the functions needed for investor protection. The obligations of the directors and staff of the insolvent institution should, broadly, be left
unchanged. The rights of suppliers to the insolvent institution should also be respected. When outsourcing arrangements are assessed by the regulators, the insolvency of both parties to the arrangement should be carefully analysed.

The real issue comes when the parent of a subsidiary goes into difficulty, rather than problems with the subsidiary, in which case the parent is expected to support. In the case of the subsidiary as well as the parent in trouble, it would have to be the administrator to ensure continuity of services with appropriate powers, rather than a firm.

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?

Please see paragraph 11 above

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

International co-ordination of proposals designed to cover internationally active firms remains essential. We think lessons can be learned from the work done in developing a regime for commercial banks, in which LIBA and its members were involved particularly closely in certain aspects, particularly in relation to the preservation of effective netting arrangements.

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

Please see our suggestions for a ‘Client assets officer’ in paragraph 9 above.

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?

Please see our reply to Question 16. We would prefer to see more “intensified engagement” by the authorities with a firm in the run up to the filing for administration or other insolvency event – an important lesson from the Lehman case.

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?

We think it will not always be easy to identify the marginal costs of extra work to comply with specific proposals, at a time when many aspects of the operation and regulation of the financial system are undergoing significant change.

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 primary source of information will be the industry itself, once proposals are sufficiently detailed to allow the necessary estimating work to be done. In relation to both Questions 25 & 26 - The “Factbook” type of exercise would be needed for the impact assessment.