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Dear Sirs,

Response of the Regulatory Law Committee of the City of London Law Society to the HM Treasury consultation document dated December 2009 entitled "Establishing Resolution Arrangements for Investment Banks" (the "Consultation Paper")

The City of London Law Society ("**CLLS**") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Regulatory Committee, whose Members advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

We are grateful for the opportunity to respond to the Consultation Paper and for your agreement to extend the deadline to accommodate our response. In view of the expertise of (and having had the opportunity to read the responses of) the CLLS Insolvency Law Committee (the "**Insolvency Committee**") and the CLLS Financial Law Committee (the "**Financial Committee**") covering the matters raised in Chapters 2, 4, 5 and 8 of the Consultation Paper, our comments are primarily directed to the other sections of the Consultation Paper, although we have addressed issues raised in these chapters where we consider that these questions could have a significant impact on the regulatory analysis. Although the questions or chapters that we have not responded to raise important issues that could well affect how insolvent firms are dealt with, we consider that others (including the other committees of the CLLS) are better placed to respond.

1. Chapter 1 - Definition and Scope

Do you have any comments on the proposed definitions of investment firm for the purposes of this work?

One aspect of the consultation that makes a detailed response difficult is the lack of a clear definition as to who will be caught by the new regime. A number of different phrases are used throughout the paper:

2.1: "investment firms";

2.7 and 2.26: "large and complex investment firms";

3.28: (referring to the May consultation) "investment firms, particularly those that are systemically important";

3.32: "in addition to systemically important investment firms, firms with client assets and monies may also fall within the scope of this proposal".

The Financial Services Bill requires Resolution and Recovery Plans to apply to "authorised persons of a specified description".

In our view, until there is clarity as to the firms who will be subject to the proposed regime, it is difficult to comment on whether the proposals are proportionate. Our submission proceeds on the basis that only firms of systemic importance will be caught. We acknowledge that the concept of what is systematically important needs further thought.

There also appears to be some confusion in the Consultation Paper about the role of investment firms. Paragraph 2.8 makes a broad generalisation that investment firms have "money and assets held on trust for clients, complex counterparty and financing positions, and collateral assets and liabilities". Whilst this may be true for a number of investment firms, the definition of an "investment firm" is extremely wide and would catch a large number of institutions who do not have any of the aspects described in paragraph 2.8. A company could be FSA regulated as an investment firm because it provides advice to clients and receives and transmits their orders to third parties. Such a firm would not fall within with the description in 2.8, nor would it be sensible for any such firm to be subject to the complex resolution arrangements described in the consultation.

In our view, many of the arrangements described in the Consultation Paper only make sense for firms of genuine systemic significance. This would exclude many investment firms. Such a definition could be derived from the FSA's proposals relating to liquidity requirements, or by the way in which the FSA currently grants permissions. For example, if HMT's policy view is that any firms who hold client money or assets on trust ought to be caught by this regime, then that could be achieved using the FSA's existing permissions and definitions. Even then, we are of the view that there are many firms of no systemic importance who have permission to hold client money and assets and, therefore, caution against using such a definition.

Inherent in much of the drafting is a lack of clarity about the underlying policy. Some of the proposals arguably should apply across investment firms which carry on particular activities regardless of systemic importance. In particular, the creation of a special administration objective preferring (as a procedural matter) the return of client assets and money which applies only to clients of a systemic investment firm appears to prejudice the position of clients of non-systemic investment firms, and would give clients of investment firms legal uncertainty as to their position on failure of the firm (which will be less favourable if the firm is not systemic). We would query whether this would be a good outcome for clients of UK investment firms.

As the authorities move to more concrete proposals it will be key that the scope of each element of the proposals is clearly defined.

2. Chapter 2 - Enabling an Orderly Resolution

2.1 Insolvency Regime

Q2. Do you agree with the Government's proposals for special administration objectives and associated policy measures? Are there any supporting levers not considered in this document that would be critical for the effective functioning of the special objectives?

In principle, we support the introduction of a special administration regime for investment firms that are systemically important.

However, we do have a concern with the return of client money or assets if the return is to only be made on the basis of confidence rather than certainty, as the return could end up proving to be preferential. At the moment, without an obligation to prioritise FSA clients, we do not think an administrator would be comfortable in prioritising in the manner set out. In this regard, we agree with the position adopted by the Insolvency Committee in their response to this Consultation Paper.

We do not think that the creation of setting up a Client Assets Trustee would assist the Government's objectives for the reasons set out in the response provided by the Insolvency Committee.

2.2 International issues

Q13 Do you agree with the Government's proposal for international entities not subject to these proposals to be able to "opt-in" to the firm-level resolution regime?

We are not aware of circumstances where other countries would be prepared to allow branches based in the UK to be wound-up in accordance with UK, rather than local law. To this extent, we agree with the opinions set out in the Insolvency Committee's response at paragraph 7 and their responses at 13 and 14 in Annex 1.

3. Chapter 3 - Requiring Firms to Manage For Failure

3.1 BROs

Q16 Do you have any views on the coverage or detail of the BRO's responsibilities as outlined here? Are these consistent or compatible with existing templates for the corporate governance structure of firms?

In our view, requiring firms to appoint a BRO is a sensible measure. We think that, without any such requirement, boards of directors would be likely to appoint one of their number to carry out a similar role. However, we think it is important that there is a time limit post-insolvency after which a BRO should no longer be required to continue in that role.

We have two comments on Table 3B. Firstly, in relation to investment firm resolution plans in distress situations, we do not think that the BRO would be in a position to oversee the effective implementation of a resolution plan. In these circumstances, we would expect the administrator to be in control of the company, and think it would be unfair for the BRO to be responsible at this time.

Secondly, in relation to Business Information Packs, in distress situations, we think that a requirement that the BRO ensures that they are "supplemented with information on trading positions" is unrealistic as these are likely to be in a permanent state of flux. Instead, we think the BRO's role should be to show the administrator how to find this information.

We note in addition that a potential conflict of interest may arise between the duties of the BRO under the resolution regime, and the duties incumbent on him as a senior manager or officer of a company. In a distress scenario, an obligation on the BRO to commence limiting risk and/or prepare for failure under the resolution regime for the benefit of the financial system as a whole, may place him in conflict with his duties to act in the best interests of the company. Clear rules on how such a conflict would be managed or regulated in practice is a key element of a working living will.

Q17 Do you agree with the basic policy of establishing a role for business resolution officers in investment firms and do you believe that this is an effective way for the FSA to ensure that the firm implements resolution actions effectively?

Yes.

Q18 What are your views on the nature of appointments of the BRO? Do you agree with the Government's suggested approach for implementing this policy, for example, the role being additional to a board member's pre-existing duties and part of the FSA's Approved Persons regime?

Yes.

3.2 **Internal and market-facing actions**

Q20 Do you agree that investment firm resolution plans can consist of internal actions followed by market-facing actions as proposed above?

In principle, we agree that this can be the case. However, it is important that market-facing actions neither alert other market participants to the firm's situation, nor favour one type of creditor over another. If market-facing actions are required to be carried out at a time when a firm is not yet in administration, they are likely to accelerate its decline into insolvency rather than allow any recovery plan to work. If a firm is considering the sale of an asset in order to maintain itself as a going concern, and is required to undertake market actions that would alert other participants to its situation, the deal to sell that asset would be affected.

In addition, in Box 3.C, the suggestion that, at the pre-insolvency stage, a firm should "begin reconciling and returning client assets and monies" may not be in the interests of the company. If, for example, the most important business line of a firm involved its holding client assets and monies, closing that business line would accelerate the decline of a firm into insolvency, rather than allow an opportunity for a recovery plan to be effective. We consider this is an example of the consultation paper potentially preferring creditors who are FSA clients over other creditors.

The implementation of wind-down plans necessarily must take effect pre-failure. This gives rise to corporate governance concerns. Senior management are generally required as a matter of corporate law to act in the interests of the institution while it is solvent, and in those of creditors on and following insolvency. A requirement to commence limiting risk and/or prepare for failure in the interest of the wider financial system would place management in a conflict between their duties to the institution (or creditors) on the one hand, and their duties to the wider financial system on the other. That conflict could ultimately carry legal liability for the senior management of the institution if their implementation of the wind-down plan is successfully challenged by shareholders or creditors following a failure of the institution. This conflict would need to be dealt with in order to enable wind-down to be a tenable decision for management.

3.3 **BIPs**

Q24 Do you agree that business information packs will be useful to administrators and will fulfil the Government's objectives for a managed wind-down of investment firms?

Yes. However, the information contained in business information packs should be designed to be useful to a potential administrator, rather than the FSA. The principle behind a business information pack should be to help an administrator navigate their way around the firm, rather than to attempt to provide up-to-date information at all times in case an insolvency event were to occur.

3.4 **Continuity of service - employees**

Q27 The Government would welcome views on what incentives and disincentives are likely to be effective and whether there are any concerns with the ones suggested above.

There are no concerns with the incentives and disincentives suggested in the Consultation. An additional disincentive might be a requirement for firms to notify the FSA of an employee who did not comply with continuity of service requirements.

The Government needs to understand that there is a risk that continuity of service contracts might be used on a widespread basis. That is because it is not always clear, prior to an insolvency, which employees need to be retained for the longest period and, given the benefit to an employee of having 90 days continued employment post-insolvency, there will be pressure on employers to include these requirements in employees' contracts. Further, we would not expect employees to be required to work 90 day periods unless the administrators could guarantee to continue to pay them on their existing terms.

3.5 **Continuity of service - suppliers**

If the Government considers it necessary to introduce measures to require service providers to continue to provide services for a 90 day period following administration, then this should be on the following basis. Firstly, that the administrators are able at the outset to guarantee to pay for the services on a day-to-day basis. In other words, instead of a single three month liability, the contractual provisions should be for day-to-day rates to be calculated on a pro-rata basis so that the administrators can terminate earlier if required, and need only guarantee on a day-to-day basis that the supplier will be paid. Secondly, we hope that this requirement is not applied retrospectively to supply agreements - these are often commercially sensitive arrangements and the financial consequences of early termination (because, for example, a supplier refuses to agree new terms) can be extensive.

Q32 What are your views on legislative changes requiring administrators to use the operational reserve only for operational expenses?

In our view, the concept of the operational reserve is misconceived. Most investment firms do not trade their own balance sheet or accept deposits, and so are currently required to keep either thirteen weeks' or six weeks' expenses as their minimum FSA capital requirement. The difference between the two depends upon the level of risk undertaken by the firm. The reason these numbers are used is that they may help to give the FSA a reasonable opportunity to arrange for the orderly wind-down of a business, while the firm's regulatory clients find a replacement firm. However, on a major insolvency, it could be that the claims against the firm exceed the operational reserve, so in practice these amounts may not afford the FSA that opportunity. It is not clear to us whether the Government is suggesting an additional operational reserve (which would then suffer from the same potential deficiencies) or whether the Government has not considered FSA's existing requirements in this regard. In our view, an additional operational reserve is unnecessary given FSA's existing capital requirements.

4. Chapter 4 - Reconciling And Returning Client Property

4.1 General

It may be true that the underlying existing protections for client money and assets are "generally fit for purpose" (paragraph 4.23 of the Paper). However the Court's decisions in relation to the Lehman Brothers ("**Lehmans**") insolvency have highlighted significant shortcomings in the drafting of the FSA's current rules on client money. The corresponding rules on client assets represent a somewhat unsatisfactory amalgam between material deriving from the EU Markets in Financial Instruments Directive and from the preceding UK regime, and are less easy to apply to intermediated securities, and to an international custody structure than is desirable. We are aware that the FSA proposes to consult imminently on changes to the relevant Sourcebook (CASS). We suggest that this process should not be confined to the specific issues raised in the Paper but should involve a thorough review of the rules as a whole. The first line of defence for client assets should be a set of rules which can be interpreted and applied without recourse to extensive guidance by the Courts.

That said, it is important that the regulatory response to the Lehmans problems does not result in imposing an over-engineered regime on smaller firms which have fewer complications.

We endorse the Government's comments in Chapter 8 of the Paper on the need for international convergence. In the context of internationally active institutions it is particularly unhelpful that there is no harmonisation, even within the EU, of the insolvency processes which apply to investment firms (which fall outside both the insurance and credit institution winding up directives and the general insolvency regulation).

4.2 Specific Responses

Q35 Should the Government look to provide clarity over how shortfalls in client asset omnibus accounts are treated on insolvency? Should the Government look to provide clarity over when clients' entitlement to their assets should be calculated?

We assume that the Government's concern on the first point relates to the holding of securities, rather than client money. The latter is of course subject a statutory trust under Sections 138 and 139 Financial Services and Markets Act 2000, and the treatment of shortfalls is dealt with in the FSA's client money regime. As mentioned above, we hope that the shortcomings in this regime identified in the Lehmans administration will be dealt with in the FSA's forthcoming consultation on CASS.

In the case of securities we agree that it is desirable to provide clarity on the treatment of shortfalls. There has been a tendency to be silent about the issue in contractual documentation, but a leading writer on custody law argues that there is an area of doubt, and that legislative or contractual provision is desirable:

> *"Where the securities of more than one client are commingled in fungible custody, there is some doubt that such clients have adequate proprietary rights in such securities. Such doubt could readily be removed by legislation. An alternative approach is contractual, establishing co-ownership rights in equity. Such wording should be included in the custody agreement as a matter of prudence."*

Any legislative solution would need to be carefully considered to avoid undue inflexibility and/or unintended consequences, and would also need to take account of the forthcoming EU Securities Directive. We concur with the concerns of both the Insolvency Committee and the Financial Committee in this regard. It may be preferable, in the interim, to adopt a regulatory solution and to require those holding client assets to set out contractually the nature of the client's interest in the assets and the way in which a shortfall will be dealt with.

The Lehmans administration has emphasised that the time at which clients' entitlements to client money are calculated can be of major importance, and that the CASS rules do not deal adequately with the issue. We agree that this should be sorted out. However we believe that a number of the difficulties arose from fluctuations in claims to a client money account which are less likely to arise in relation to securities held in custody, so there may be less need to deal with the issue in the custody context.

Q36 Do you agree with the Government's proposal of mandating warnings over the implications of allowing rehypothecation and omnibus accounts in relevant agreements? Should firms be required to offer clients designated named accounts at custodians?

We are not convinced that mandating warnings in agreements is either necessary or desirable for the following reasons:

(a) It seems to us that one of the better developments over the last few years has been to move away from requiring the mechanical inclusion of specific risk warnings in favour of a more general obligation on an investment firm to provide appropriate information about the risks of investment.

(b) There is a distinct risk that such warnings will be construed as some kind of acknowledgement on the part of the client that it does not have rights which might otherwise be available to it under the general law. For example a statement that "Your assets may not be protected" in specified circumstances may make it more difficult for the client to argue that as a matter of law they are.

We suggest that "clarity" is better served by ensuring that the client's contractual rights in relation to an omnibus account or rehypothecation are clearly and fully set out. If specific risk warnings are desirable at all then we suggest that placing them in the relevant agreement is not the best way of drawing them to the attention of the client. Such agreements are typically either read by the client's legal advisers (who should not need the warnings) or not read at all.

We agree with the Financial Law Committee's response to this question, in that the availability of designated named accounts should be left to the market since this involves matters of cost and settlement efficiency. In any case achieving segregation right through an international custody/sub-custody structure is likely to be difficult if not impossible to achieve.

Q39 Do you agree with the Government's proposal of increased reporting requirements for systemic investment firms? If so, are there any issues around the timing or content of reporting that the Government should consider?

It is difficult to argue against such reporting requirements, though we must leave it to industry participants to comment on their practicality. So far as we can see the Government has not indicated what it means in this context by "systemic investment firms". We would be concerned if the requirement for daily reporting were to apply to the activities of a custodian providing, for example, custody of a portfolio of securities involving no derivatives, stock lending or leverage. (See also our general comments on the application of the Government's proposals at the beginning of this submission.)

Q40 Do you agree with the Government's proposals for increased record-keeping requirements for investment firms? Should the Government require settlement date record-keeping, as well as trade date record-keeping on custody systems?

The proposals appear to be sensible.

Q41 Do you agree with the Government's support for increased audited disclosures by firms around client money and assets? Should Government require firms to make available audited client money and assets reports to clients?