EXPLANATORY MEMORANDUM TO

THE INVESTMENT BANK SPECIAL ADMINISTRATION REGULATIONS 2011

2011 No.

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty. This memorandum contains information for the Joint Committee on Statutory Instruments and for the Merits Committee.

2. Purpose of the instrument

2.1 These Regulations provide for a new special administration regime (SAR) for investment banks (as defined in section 232 of the Banking Act 2009).

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 Normally, the introduction of a new administration regime for a certain type of firm would be made under primary legislation. However, here the Regulations are being made under the enabling powers in section 233 and 234 of the Banking Act 2009[1] ("the Banking Act").

4. Legislative context

4.1 The Treasury lays the following Regulations in exercise of the powers conferred by sections 233, 234 and 259(1) of the Banking Act (the power in section 233 and 234 having not yet lapsed under section 235(4)). These Regulations need to be approved by both Houses of Parliament and are linked to a separate Order "The Investment Bank (Amendment of Definition) Order 2011" which amends the scope of this regime as set out in section 232 of the Banking Act. The Regulations must be made by the 11 February 2011 or, in accordance with section 235(4) of the Banking Act, the powers to make them will lapse.

4.2 Following the insolvency of Lehman Brothers, it became apparent that there were unanticipated complexities in resolving an investment bank. Essentially, the issues stemmed from the complex ways in which client money and assets are held by broker dealers. This caused delays in allowing the administrator to identify and return assets to clients. This has major implications for the attractiveness of the UK as a place to conduct prime brokerage business, with potential knock-on consequences for UK competitiveness in general.

4.3 In response to these concerns, the Treasury undertook an in-depth review to assess whether there are shortfalls with existing insolvency law regarding investment firms which hold client assets. Powers were then provided for in the Banking Act (sections 232 to 236) to enable the Treasury to create a new insolvency regime, if the review found it to be necessary.

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[1] 2009 c.1

4.4 The Treasury gave undertakings that it would base its decision to create a new SAR for investment firms both on the outcome of public consultation and on the advice of its Investment Banking Liaison Panel of industry experts.

5. Territorial extent and application

5.1 This instrument applies to the United Kingdom.

6. European Convention on Human Rights

6.1 The Commercial Secretary to the Treasury, Lord Sassoon, has made the following statement regarding Human Rights:

"In my view, the provisions of The Investment Bank Special Administration Regulations 2011 are compatible with the Convention rights."

7. Policy background

- **What is being done and why**

Problem under consideration

7.1 The failure of Lehman Brothers in the UK and the subsequent administration proceedings have demonstrated areas where the UK's insolvency regime can be improved. For example, the administrators have faced substantial difficulties in returning trust assets and money to clients under their current statutory powers.

Rationale for intervention

7.2 The Government believes that there is a strong case for a SAR for investment firms to ensure that there is minimum disruption to financial markets as a result of their insolvency. It is important that client trust property is returned promptly on the insolvency of an investment firm in order to mitigate the possibility that clients are forced into financial difficulties themselves. The prompt return of client assets will also benefit the insolvent firm's unsecured creditors as their claims can be dealt with quicker and administration expenses will be reduced.

Scope

7.3 Currently a firm is within scope of the SAR if it satisfies the following conditions:

a) has permission under Part 4 of the Financial Services and Markets Act 2000 (FSMA) to carry on at least one of the following regulated activities:
   - safeguarding and administering investments;
   - dealing in investments as principal; or
   - dealing in investments as agent;
b) holds client assets; and
c) is incorporated in, or formed under, the law of any part of the UK (includes companies, limited liability partnerships, and partnerships).

7.4 The Government intends to use the order-making power in section 232 of the Banking Act to provide that the term "client assets" in Condition 2 (section 232(3)) also includes client money. This is to ensure that a firm which holds client money or client assets is within scope of the SAR if it satisfies the other conditions. The exception to this are firms which hold client money related to insurance mediation activities that are not part of investment activities. These firms will be excluded as the SAR is meant to apply to investment firms. This amendment to the Banking Act is set out in a separate order which is to be laid at the same time as these Regulations.

Special administration objectives

7.5 The SAR will create three special administration objectives which administrators will have a duty to follow:

- Objective 1 is for the administrator to ensure the return of client money or assets as soon as is reasonably practicable;
- Objective 2 is for the administrator to ensure timely engagement with market infrastructure bodies and the Authorities; and
- Objective 3 is for the administrator to either rescue the investment bank as a going concern, or wind it up in the best interest of the creditors.

7.6 The administrator has the flexibility to prioritise these objectives as appropriate so they are suitable for any size of investment firm which holds client money or assets and is within scope.

7.7 The aim is to provide administrators with clarity and direction to resolve the firm, without needing to approach the court on a frequent basis.

FSA's power of direction

7.8 The FSA, after consultation with HM Treasury and the Bank of England, has the power to direct the administrator to prioritise certain objectives over others, if it is necessary to maintain public confidence in the stability of the UK financial markets. This direction from the FSA will give administrators an additional defence to undertake certain actions which otherwise they may be reluctant to undertake due to concerns over their personal liability for their actions.

Bar dates for claims to client assets

7.9 It is hard for an administrator to start returning client assets until they have complete information on all claims to the assets. Not having a cut-off date after which the administrator can start reconciling claims can cause a severe delay in the return of client assets.

7.10 The SAR gives an administrator the option of setting a "bar date" (i.e deadline) if they think it is necessary to expedite the return of client assets.

7.11 The bar date should allow:

- sufficient time for the fact of administration to be publicised;
- sufficient time for affected clients to calculate and submit their claims; and

- sufficient time for practical difficulties in establishing claims, particularly where arrangements are complex, to be sorted out.

7.12 A late claimant is not allowed to challenge the distribution of the administrator as long as it is conducted in good faith. This is to give certainty to clients who receive back their assets that they will not be challenged at a later date by a third party for the return of those assets.

7.13 To reduce the possibility of there being a late claimant there are safeguards. For example, the administrator must set a reasonable timeframe for submission of claims, and proactively approach any client who is on the books and records of the firm as having a potential claim. Further safeguards are to be set out in the Investment Bank Special Administration Rules- see paragraphs 7.22 – 7.24 below.

7.14 In addition, no distribution can be made by the administrator following the bar date until the creditor committee has approved the administrator's distribution plan and court approval has been obtained.

Allocation of shortfalls in an omnibus account

7.15 There is currently a lack of clarity in insolvency law over how shortfalls in client securities held in an omnibus account should be allocated to clients. This uncertainty can delay the return of client assets, and increase the costs of administration.

7.16 The SAR provides the administrator with the power to allocate shortfalls in client securities pro rata in an omnibus account. The inclusion of this power aims to get client assets returned quicker thereby resulting in a less costly administration for creditors.

Continuity of service arrangements

7.17 The Government is seeking to ensure that suppliers of services which are key to the effective administration of the firm and to the meeting of the special administration objectives cannot withdraw their services until the administrator has had time to make suitable alternative arrangements. The SAR adapts the provisions of section 233 of the Insolvency Act 1986 to require continuity of supply of IT and other key services. When an investment firm goes into administration, the supplier cannot make it a condition of the supply, or do anything that would have the effect of imposing that condition, that any outstanding charges owed by the firm to the supplier and incurred before the date of administration are paid. Suppliers of the following are covered:

- computer hardware or software or other hardware used by the investment bank in connection with the trading of securities or derivatives;
- financial data;
- infrastructure permitting electronic communication services;
- data processing;
- secure data networks provided by an accredited network provider; or
- access to a relevant system by a sponsoring system participant.

7.18 The supplier can stop providing a supply if: any charges in respect of the supply, (i.e. charges incurred post the commencement of Special Administration) remain unpaid for more than 28 days; the administrator consents to the termination; or the supplier has the permission of the court. The latter may be given if the supplier can show that the continued provision of the supply shall cause the supplier to suffer hardship.

Interaction of the SAR with the Banking Act for deposit-taking firms

7.19 The interaction between the SAR and the provisions under Parts 2 and 3 of the Banking Act is as follows. Where the investment bank is a deposit-taking bank with eligible depositors then, in addition to the insolvency procedures established under Parts 2 and 3 of the Banking Act, the Bank of England may apply to put the bank into:

- Special Administration (Bank Insolvency); or
- where a property transfer power under Part 1 of the Banking Act 2009 has been exercised, Special Administration (Bank Administration).

7.20 The FSA may also make an application for Special Administration (Bank Insolvency) with the consent of the Bank of England.

7.21 However, where the investment bank is a deposit-taking bank but has no eligible depositors, the investment bank may be put into either:

- Special Administration (Bank Administration); or
- Special Administration.

Investment Bank Special Administration Rules

7.22 There will be insolvency rules for the SAR for England and Wales, for Scotland, and for Northern Ireland. The English and Welsh rules and the Scottish rules are to be made under section 411 of the Insolvency Act 1986 (as applied by the Regulations). The Northern Ireland rules are to be made under Article 359 of the Insolvency (Northern Ireland) Order 1989 (as applied by the Regulations). The English and Welsh rules will be put before the Insolvency Rules Committee, as required by the Insolvency Act 1986.

7.23 These rules will be introduced separately under the negative procedure to come into force as soon as possible after the Regulations come into force.

7.24 These rules will set out the procedural rules which the administrator has to follow in order to comply with the Regulations. The main new provisions include:

- clients being present at the meeting of creditors;
- clients being represented on the creditor committee;
- costs of returning client assets will be paid out of the client assets; and
- the bar date procedure (incorporating various safeguards) and how late claimants are to be to treated.

- **Consolidation.** Not applicable.

8. Consultation outcome

8.1 The Treasury has consulted in accordance with section 235(3) of the Banking Act. There have been three consultations[1] on the SAR. The responses from the three consultation papers have been considered and have informed the policy development of the SAR. Responses to the consultation papers are available on the Treasury's website[2].

8.2 Responses to the most recent consultation paper on the SAR, *Special administration regime for investment firms*[3], which consulted on the actual draft Regulations, were broadly supportive of the introduction of this new regime. The Treasury has considered all amendments raised by the respondents and all subsequent changes to the Regulations are set out on HM Treasury's website[4].

8.3 The Treasury has also taken account of the views of an Investment Banking Liaison Panel of industry practitioners who have helped to develop the SAR.

9. Guidance

9.1 Not applicable.

10. Impact

10.1 The SAR may only be instituted in connection with the insolvency of an investment bank (as defined in section 232 of the Banking Act). There are no significant ongoing or one-off direct costs associated with the SAR. The Treasury has consulted on the costs of the SAR being negligible and there was no serious contention of this assumption apart from the highlighting by some respondents of the potential costs resulting from planning for or risk assessing the new administration regime. This might occur where market participants have to obtain new legal opinions. However, responses have not given any indication of the scale of these costs. An Impact Assessment has been prepared for this instrument.

11. Regulating small business

11.1 These Regulations apply to 'investment banks' (as defined in section 232 of the Banking Act 2009) some of which may be small businesses.

12. Monitoring & review

12.1 Section 236 of the Banking Act provides for HM Treasury to review the special administration regime insolvency regulations within two years of them coming into force. The review must consider how far the regulations are achieving the objectives specified in section 233(3) and whether the regulations should continue to

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1 *Developing Effective Resolution Arrangements for Investment Banks*, HM Treasury, May 2009; *Establishing Resolution Arrangements for Investments Banks*, HM Treasury, December 2009; and *Special Administration Regime for Investment Firms*, HM Treasury, September 2010

2 www.hm-treasury.gov.uk/consult_investment_banks2.htm.

3 www.hm-treasury.gov.uk/d/consult_sar_160910.pdf

4 www.hm-treasury.gov.uk/consult_investment_banks2.htm.

have effect. HM Treasury will ensure that arrangements for review are consistent with better regulation policy going forward.

13. Contact

Daniel Okubo at HM Treasury can answer any queries regarding the instrument.
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