DechertOnPoint

August 2011 / Issue 12

A legal update from Dechert's Financial Services Group

The New UK Insolvency Regime for Investment Firms

In this *DechertOnPoint*, we summarise HM Treasury's work to establish effective resolution arrangements for investment banks and firms, which resulted in the introduction of a special administration regime ("SAR") earlier this year.

Introduction

The Government embarked on a review of resolution arrangements for investment banks and firms following the failure of Lehman Brothers International (Europe) ("LBIE") designed to improve the UK's ability to deal with the failure of investment firms (specifically large and complex firms), by addressing the policy issues highlighted by the failure of LBIE.

The review was announced in the 2008 Pre-Budget Report and also referred to in the 2009 Budget.

Before the collapse of LBIE, the impact of insolvency of a major investment bank on client assets and money had not been fully factored into market expectations, either in the UK or in other jurisdictions. The significant impact this has had in practice, including the difficulties experienced by the LBIE administrators in returning trust assets and money to clients under their existing statutory powers, highlighted the importance of ensuring that client assets and money are returned promptly following insolvency.

HM Treasury's review was carried out under powers granted to it in the Banking Act 2009 (the "BA 2009") which was enacted in February 2009 to strengthen financial stability and depositor protection relating to authorised deposit-taking banks in the UK. Amongst other things, the BA 2009 set out a pre-insolvency stabilisation mechanism for banks in financial difficulties and in need of emergency measures to protect depositors ("the special resolution regime") together with two insolvency procedures:

- Bank Insolvency (Part 2 of the BA 2009): this essentially provides for the liquidation of the bank as the purpose of the process is to transfer all the bank's deposit-taking business to a purchaser or a bridge bank; and

- Bank administration (Part 3 of the BA 2009): this provides for the appointment of an administrator to support the partial transfer of a bank's business to a purchaser or bridge bank, and the ongoing running of the residual bank, either as a going concern or as part of an orderly winding up process.

However, at the time of the LBIE collapse, the BA 2009 excluded investment banks from the insolvency procedures set out above, to the extent they were not authorised deposit-taking institutions. Section 232 of the BA 2009, in summary, defined "investment bank" as an institution authorised to carry on certain regulated activities related to investments, that holds client assets and is incorporated or formed under UK law.

Sections 233 to 236 of the BA 2009 gave HM Treasury the power to introduce future legislation modifying insolvency law to introduce a new regime to improve the UK's ability to deal with the failure of an investment bank. It is this power that HM Treasury ultimately exercised when it introduced the special administration regime for investment banks in February 2011.

HM Treasury's Report in May 2009 on Developing Effective Resolution Arrangements for Investment Banks

In May 2009, HM Treasury published a report on developing effective resolution arrangements for investment banks. The report identified the return of client assets following the insolvency of an institution as one of the key areas that need to be addressed, in order to maintain financial stability and protect the reputation of London as a global financial centre.

Under the rules at the time, there was no particular duty on the administrators to prioritise the return of client assets, some of which may be subject to third party rights of use (that is, re-hypothecation). Consequently, there had been a lack of clarity about the ability of the UK regime to protect clients in an insolvency scenario. The report, therefore, explored whether some of the issues relating to client assets could be addressed through market and regulatory measures. It did not set out concrete policy recommendations but instead highlighted the areas where reform could be explored.

The report, therefore, focused on issues relating to the return of client assets and money in the event of the commencement of insolvency proceedings. In particular, it considered cases where effective segregation had not occurred, or where complex liens or set-off arrangements existed, or re-hypothecation had occurred. It explored existing arrangements, the extent of potential problems, and the scope for addressing them through legislative, regulatory or market solutions. Any proposed regulatory changes were for the Financial Services Authority (the "FSA") to consider and take forward by way of consultation.

The issues relating to the prompt return of client assets and money were addressed in the discussion paper. The specific objectives that the Government sought to achieve through its proposals were:

- to ensure clarity about how client assets and monies are treated on insolvency, and to address any misconceptions;
- to facilitate the identification and legal categorisation of client assets and money following the commencement of insolvency proceedings, and the legal categorisation of a client's rights in respect of those assets and money, which would involve:
  - resolving practical issues through better record keeping and reporting;
  - providing information about the segregation and re-hypothecation of assets; and
  - establishing legal clarity about the basis on which assets are held;
- to speed up the return of client assets and money which could involve:
  - changes to the use of third party custodians and affiliates for holding client assets and money;
  - changes to the way in which client money is segregated;
  - changes to arrangements for set-off and liens;
  - the establishment of bar dates to crystallise claims;
  - changes to the regime around re-hypothecation;
  - the creation of special officeholders or objectives for reconciling client assets as a matter of priority; and
  - the establishment of bankruptcy-remote vehicles for holding client assets that are not being taken as collateral by way of title transfer, or that are being treated as excess collateral, to establish market-led forms of client asset protection; and
- to ensure that sufficient flexibility is maintained to enable investors and brokers to arrive at mutually acceptable outcomes, and to ensure that any new regime is both "futureproof" and has no substantial negative impacts.

Reforms proposed in the report were intended to apply to investment banks holding, managing or directing client assets.

HM Treasury said that it would work with a specialist advisory panel of investment banking, insolvency, legal and other experts, as well as the FSA and the Bank of England to address the technical issues arising from its proposals.

Subsequently, HM Treasury published a more detailed consultation paper in December 2009.

HM Treasury's Consultation in December 2009 on Establishing Effective Resolution Arrangements for Investment Banks

In December 2009, HM Treasury published a consultation, "Establishing resolution arrangements for investment banks".

This set out proposals for a new administration regime for a failed investment firm. This would ensure that the administration of a failed firm is conducted with due regard to financial stability and the proper functioning of markets, as well as with reference to the need for the speedy recovery of assets for clients, and the reconciliation of counterparty positions. It also set out proposals for new regulatory requirements, under which firms would play a leading role in managing for their own failure, and outlined a package of policy initiatives which consider legislative, regulatory and industry solutions to address client money and assets issues, and are designed to mitigate the impact of any future investment bank failure on the financial markets. In particular, the proposals aim to speed up the return of client money and assets and set out proposals for reconciling and returning client money and assets. The proposals built on those set out in May 2009 discussion paper, and include the following:

- clarifying the treatment of client assets on insolvency, by ensuring that the allocation of shortfalls in a client asset omnibus account is proportionate to clients' entitlement;
- mandating warnings in agreements that would clearly set out the implications of allowing re-hypothecation and the use of omnibus custodian accounts to hold client money and assets;
- encouraging clarity in agreements, by encouraging investment firms to be transparent over any risks to client money and assets protection;
- increasing reporting and record-keeping requirements;
- increasing auditing disclosures by firms to the FSA about the holding of client money and assets;
- making client asset officers directly accountable, by clarifying the FSA controlled function 29 (significant management), so that the FSA is able to ensure that the people in charge of directing client assets are fully qualified and capable of executing their duties;
- supporting the establishment of bankruptcy-remote special purpose vehicles ("SPVs") for client assets, to ensure that the return of client assets is not affected by the firm's insolvency;
- placing limitations on the ability of investment firms to transfer client money to affiliate entities and jurisdictions where this would be incompatible with protections in CASS;
- ensuring that the custodian has no lien or right of retention over client accounts, and that it will not seek to combine, net, or set off the account against the debts or obligations of the firm;
- requiring firms to have the ability to divide client money into different pools, for example, according to the type or risk of the investments involved, and
- establishing bar dates for client claims by creating a statutory scheme with fixed terms under which claims have to be received to help speed up the process of determining clients' entitlements.

A further paper outlining the Government's final proposals together with draft secondary legislation, as necessary, was published in September 2010.

HM Treasury's Consultation in September 2010 on a Special Administration Regime for Investment Firms

HM Treasury's September 2010 consultation set out the Government's final proposals for a SAR for investment firms. These proposals took forward the outline proposals in HM Treasury's second consultation on this topic, which was published in December 2009.

The SAR is designed to strengthen the UK's ability to deal with future investment firm failures. It will take the form of an administration procedure with special administration objectives ("SAOs") which the administrators have a duty to follow:

- Objective 1: to ensure the return of client money or assets as soon as is reasonably practicable.
- Objective 2: to ensure timely engagement with market infrastructure bodies and the Authorities (i.e. the Bank of England, HM Treasury and the FSA).

- Objective 3: to either rescue the investment firm as a going concern, or wind it up in the best interest of the creditors.

The main features of the SAR were set out in the consultation. The proposed special insolvency rules for the SAR were also outlined in it. The Government said that the SAR will give administrators clarity and direction to conduct investment firm administrations without needing to make frequent applications to the court for directions. In addition, the adjustments the SAR will make to the existing insolvency regime should make the process less expensive and less disruptive. The government also hoped that the SAR will give clients and counterparties greater confidence in the administrative process and, as a result, reduce the impact of an investment firm's insolvency on the stability of the UK financial system.

The Final Regulations Implementing the Special Administration Regime for Investment Banks Published in January 2010

In January 2011, HM Treasury published revised draft Regulations. The Regulations set out the statutory objectives of the court appointed administrator in an SAR situation (the first of which is to ensure the return of client assets to clients as soon as is reasonably practicable).

The revised draft Regulations contained comprehensive, if minor, editing of the original draft (consulted on in September 2010), together with a small number of substantive changes. The key changes made to the Regulations following consultation:

- clarified that the definition of "client assets" in the Regulations expressly includes money held on behalf of clients;
- clarified when an administrator can return unsegregated assets;
- introduced additional safeguards for clients where an administrator introduces a bar date for the submission of claims;
- improved the process of allocating shortfalls pro rata to clients;
- dispensed with the need for the administrator to obtain approval of a creditors' committee before complying with a direction from the FSA to prioritise one or more of the objectives of the special administration;
- revised the objective of co-operation with market infrastructure bodies (including requests from an overseas market infrastructure body);
- added providers of hardware and data networks to the list of essential services that cannot be terminated on insolvency as long as they are paid; and
- clarified which types of procedures are available under the investment bank SAR, and which are available under the insolvency regimes under the Banking Act 2009, and whether a particular set of statutory objectives takes precedence. This is to address the fact that the terminology under the different regimes is very similar and can be confusing.

The Investment Bank Special Administration Regulations 2011

The Investment Bank Special Administration Regulations 2011 (*SI 2011/245*) came into force on 8 February 2011 (The Regulations were introduced under powers in sections 233 and 234 of the Banking Act 2009.) The contents of these Regulations are as follows:

Regulation 3 gives an overview of the new regime.

Regulation 4 provides for the appointment of an administrator by special administration order.

Regulation 5 prescribes those who may apply to the court for a special administration order.

Regulation 6 sets out the grounds under which an application for a special administration order may be made.

Regulation 7 sets out the powers of the court when faced with an application for a special administration order.

Regulation 8 sets out four conditions that must be fulfilled before an investment bank can be put into other insolvency proceedings.

Regulation 9 provides that Schedules 1 and 2 apply where the investment bank is a deposit-taker.

Regulation 10 sets out the three special administration objectives and the duty on the administrator to achieve the objectives.

Regulation 11 (in respect of the first special administration objective) gives the administrator a power to set a bar date for the submission of claims over the client assets held by the investment bank, and provides for the treatment of claims received after the bar date and after a distribution of assets has taken place.

Regulation 12 (also in respect of the first special administration objective) prescribes how the administrator is to deal with a shortfall in the amount of client assets held by the investment bank in a client omnibus account.

Regulation 13 sets out details of the second special administration objective that the administrator is to work with market infrastructure bodies to facilitate the operation of default rules and arrangements and the settlement of trades, and with the Authorities (the Bank of England, Financial Services Authority and the Treasury) to facilitate any actions the Authorities might take as a result of the special administration.

Regulation 14 provides for the continuation of certain supply contracts on the commencement of special administration.

Regulation 15 applies relevant provisions of the Insolvency Act 1986 with modification where necessary.

Regulation 16 provides a power for the Financial Services Authority (the "FSA") to direct the administrator to prioritise one or more of the special administration objectives where the FSA think it necessary to protect the stability of the financial systems of the United Kingdom or public confidence in the financial markets.

Regulation 17 provides for the drawing up of the statement of proposals in the event of the FSA having given a direction.

Regulation 18 provides for the revision of the statement of proposals in the event of the FSA having given a direction.

Regulation 19 provides for the revision of the statement of proposals in the event of the FSA having withdrawn its direction.

Regulations 20 and 21 provide for the ending of special administration.

Regulation 22 provides for a special administration order to be made as an alternative order to a winding up petition or an administration order under Schedule B1 to the Insolvency Act 1986.

Regulation 23 modifies the Company Directors Disqualification Act 1986 to apply in respect of special administration.

(Regulations 24 to 27 merely provide that Schedules 3 to 6 have effect.)

Schedule 1 modifies the new regime for use as an alternative to bank insolvency as set out in Part 2 of the Banking Act 2009.

Schedule 2 modifies the new regime for use as an alternative to bank administration as set out in Part 3 of the Banking Act 2009.

Schedule 3 modifies the new regime for limited liability partnerships.

Schedule 4 modifies the new regime for partnerships.

Schedule 5 lists the enactments referred to in the Regulations with their Northern Irish equivalents and any necessary modifications.

Schedule 6 sets out modifications and consequential amendments to legislation.

An Impact Assessment on the effect of the introduction of the new special administration regime has also been prepared and may be obtained from the Financial Regulatory Strategy Team at HM Treasury.

The related Investment Bank (Amendment of Definition) Order 2011 (*SI 2011/239*), which amends the scope of the SAR for investment banks as set out in section 232 of the Banking Act, also came into force on 8 February 2011. This Order was made under section 232 of the Banking Act 2009, and provided that the definition of "client assets" includes client money. This was to ensure that a firm which holds client money or client assets is within scope of the SAR if it satisfies the other conditions. However, insurance intermediaries that hold client money will not fall within the SAR which is meant to apply to investment firms only.

At the time the Regulations were made, the Government indicated that it would introduce insolvency rules to accompany the Regulations. The Investment Bank Special Administration (England and Wales) Rules 2011 (*SI 2011/1301*) (the "2011 Rules") came into force on 30 June 2011, The 2011 Rules set out the procedural rules that an administrator must follow in order to comply with the Regulations. A detailed discussion of these rules is beyond the scope of this *DechertOnPoint*, however.

FSA-related Work on Client Assets and Resolution Management

Separate to HM Treasury's work, the FSA has taken forward work on some of the Government's proposals concerning client assets and money. In particular, these include publication of a March 2010 consultation paper considering seven of HM Treasury's proposals, which address increased re-hypothecation disclosure and transparency, enhanced client money and asset protection, and increased CASS oversight.

The FSA also confirmed in its 2011/21 business plan that recovery and resolution plans ("RRPs") (also referred to as "living wills") will continue to be a key area of work. RRPs are intended to help ensure that the FSA can manage the failure of a major bank and tackle the risk that certain banks are "too big to fail".

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