Linklaters

February 2011

New special administration regime for investment banks.

Contents

Background to the Regulations 1

What is an investment bank? 2

The special administration regime 2

Objective 1 – the return of client assets..................... 3

Objective 2 – working with the markets...................... 4

Continuity of supply 4

Banks that are also investment banks.............. 5

Future developments 5

Executive summary

A new special administration procedure for investment banks has been created by the introduction of The Investment Bank Special Administration Regulations 2011 (the "**Regulations**"). An administrator appointed under the Regulations will have new special administration objectives which include:

- to return client property as soon as reasonably practicable; and
- to co-operate with the markets in resolving failed trades.

Other key changes introduced by the Regulations are:

- administrators will be able to set a bar date for asset claims;
- the rules governing losses for shortfalls of client securities are clarified; and
- suppliers of key services are obliged to continue to supply them to the administrator.

This briefing examines the Regulations and how, if at all, they may impact on the law and practice of administering a failed investment bank.

Background to the Regulations

The Regulations came into effect on the 8th February 2011 and provide for a new special administration regime to apply to insolvent investment banks.

Following the collapse of Lehman Brothers and the ensuing financial crisis, the regulators became acutely aware that the insolvency regime applicable to investment banks would need to be carefully reviewed to ensure that it was fit for purpose. There were views expressed that the UK regime compared unfavourably with those in other jurisdictions, particularly when dealing with protection of client assets and money. At the same time, other views were expressed that hasty reform could be both unwise and counter-productive. As a result it was decided not to include any specific reform addressing investment banks in the Banking Act 2009 (the "**Banking Act**") but instead to provide an enabling power to pass new regulations to apply to insolvent investment banks within 2 years. The 2 years expired in February 2011.

Extensive consultation has taken place with the industry, professional advisors and users of investment banking services. Linklaters participated in these consultations through the government's Investment Banking Liaison Panel of industry experts. HM Treasury produced a series of consultation papers inviting submissions during which thinking evolved significantly and the Regulations reflect the outcome of those consultations. The focus has been to ensure that the UK remains an attractive place for investment banking business and that customers can continue to deal with UK investment banks with confidence.

The principal area of concern has been overcoming difficulties with dealing with the return of property and money held for clients. In practice, as it has turned out in the case of Lehman Brothers, through the use of non-insolvency based arrangements such as the contractual Claims Resolution Agreement, the UK has managed to address some of the more challenging aspects of the return of securities held for clients reasonably effectively and, in some respects, rather better than in some of the other jurisdictions where client assets are held. Linklaters acted for the administrators of Lehman Brothers International (Europe) ("**Lehman UK**") in the creation of the Claims Resolution Agreement. However, such arrangements may not always be available in future and the Lehman Brothers insolvency did reveal a number of areas where the law could be improved, often by incorporating into law ideas first advanced in the Claims Resolution Agreement. That is what the Regulations seek to address.

What is an investment bank?

The Regulations apply to investment banks which are defined in the Banking Act as institutions which:

- have permission under Part 4 of the Financial Services and Markets Act 2000 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;

- hold client assets (whether or not on trust); and

- are incorporated or formed in the UK (so this would include partnerships).

At the same time as the Regulations came into force, The Investment Bank (Amendment of Definition) Order 2011 clarified that, for these purposes, client assets include client money. They also clarified that the Regulations do not apply to insurance intermediaries.

The special administration regime

The Regulations create a new procedure called "special administration" which can apply to investment banks. The special administration regime ("**SAR**")

creates 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 interests of the creditors.

The administrator has flexibility to prioritise these objectives as appropriate, so the administrator will not be required to return all client assets before addressing unsecured creditors. In many respects, it could be argued that this statement of objectives is little more than a statement of the pre-existing law of what the administrator of an investment bank should do anyway but it is perhaps a helpful clarification. The FSA does have the power, having consulted with the Treasury and the Bank of England, to direct the administrator to prioritise certain objectives over the others, if that is necessary to maintain public confidence in the stability of the UK financial markets. This may be helpful to the administrators in providing them with a defence to undertaking (or failing to undertake) certain actions which might otherwise expose them to personal liability.

Objective 1 – the return of client assets

Objective 1 relates to the return of property after discharge of claims on those assets. In reality, it is the customer's net equity that must be returned. Without more, an administrator would face difficulties in returning client assets before all claims to those assets have been asserted. Accordingly, the Regulations allow the administrators to set a "bar date" for claims to assets to help speed up the return process. Although under the ordinary administration procedure a bar date may also be set for client asset claims (one was set in Lehman's UK administration for example), the risk remains that late claimants could seek to recover from their recipients assets which had been distributed to them by the administrator. The Regulations remove this risk and make the bar date more effective. Claims made after the bar date will not be able to upset the returns of assets already made (other than where bad faith is present). There are a number of safeguards to the process that have been built in including timing, publicity and a requirement for creditor committee and court approval.

Objective 1 also addresses an issue which was troubling in Lehman about the allocation of losses arising from shortfalls of securities if it should turn out that there are more claims to assets than actual assets held by the investment bank. Under general trust law, there are a number of possible alternative theories which might apply to allocate the loss and each produces a different result. The Regulations provide that loss will be ascertained for each particular type of stock (by CUSIP or ISIN) and borne pro rata by all claimants to securities of that kind. If there is a shortfall after that allocation then that will

give rise to an unsecured claim (based on the value of the securities on the date the special administration commenced). This is the same mechanism that Lehman UK used in the Claims Resolution Agreement and the Regulations give it statutory effect. It should be noted that this rule does not apply to client money claims which continue to be allocated and dealt with under the FSA's client money rules as set out in CASS. Those continue to be the source of some dispute and are under review. The client money rules are imminently to be subject to revisions and it was felt not appropriate to address them in these Regulations.

Objective 2 – working with the markets

Objective 2 requires the administrator to work with market infrastructure bodies in applying their default rules and resolving unsettled trades or settlement instructions. In the Lehman UK insolvency, one particular area of concern in the markets was the time and complexity of resolving failed trades. The Regulations attempt to address this by providing a specific special administration objective. The Lehman UK insolvency showed that there was scope for improvement in these arrangements so as to minimise disruption.

Continuity of supply

The Regulations also seek to ensure that suppliers of key services needed for the special administration objectives cannot withdraw their services until the administrator has had time to make suitable alternative arrangements. The Lehman UK insolvency showed that disruption in the supply of key data and services could severely delay the return of client property and disrupt the activities of the administrators. The Regulations require continuity of supply of IT and other key services. When an investment bank goes into special 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 of the 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;
- secured date networks provided by an accredited network provider; or
- access to a relevant system by a sponsoring system participant.

The supplier can stop providing supply if charges since the date of commencement of the special administration are unpaid for more than 28 days, or with consent of the administrator or leave of the court. Court permission will be given if the supplier can show that continuing the supply

will cause him hardship. Similar rules governing continuity of supply of utilities already apply under the Insolvency Act 1986.

Banks that are also investment banks

Many of the institutions to which the Regulations apply will also be UK banks falling within the operation of the Banking Act. Under the Banking Act, the regulators may apply the Special Resolution Regime under Parts 2 and 3 of that Act to a bank which is also an investment bank. Much of the detail of the Regulations addresses how they will operate for a bank which is also an investment bank. Regrettably, this results in the creation of yet two more new insolvency regimes:

- Special Administration (Bank Insolvency) – this is an alternative to “bank insolvency” (as set out in part 2 of the Banking Act) where the investment bank is also a deposit taking bank. It is substantively the same as the investment bank special administration procedure but modifies it to give priority to the administrator to work with the Financial Services Compensation Scheme in connection with the transfer of deposits to another financial institution; and
- Special Administration (Bank Administration) – this is an alternative to “bank administration” (as set out in Part 3 of the Banking Act) where part of the business of the deposit taking bank is sold to a commercial purchaser or transferred to a bridge bank. It is substantively the same as the investment bank special administration procedure but modifies it to give priority to the administrator to provide support to the purchaser.

Future developments

Much of the detail of the Regulations will be in the form of new insolvency rules for the SAR. These are not yet in place and will, we are told, be introduced shortly to come into force as soon as possible. They will provide for the mechanics of creditors meetings, the creditors committee and bar date procedures. They will also provide that the costs of returning client assets will be paid for out of the client assets. That reflects the rule in *Re Berkeley Applegate* but is helpful clarification for administrators and unsecured creditors. Of course, without rules being in place the Regulations are only partially effective at the moment.

Under the Banking Act, the Treasury is required to review the operation of the Regulations within 2 years of their coming into effect (i.e. before 8 February 2013). The review must consider how far the Regulations are achieving their objectives as set out in the Banking Act and whether the Regulations should continue to have effect. In the absence of another investment bank failure over that period it is likely that any review will concentrate on what impact, if any, the Regulations have had on maintaining confidence in the UK as a good place to conduct investment banking business. There are many factors (of which these Regulations may be only a small one) which could impact that.

Contacts

For further information please contact:

David Ereira
Partner

(+004) 207 456 2134

david.ereira@linklaters.com

Author: David Ereira

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

© Linklaters LLP. All Rights reserved 2011

Linklaters LLP is a limited liability partnership registered in England and Wales with registered number OC326345. The term partner in relation to Linklaters LLP is used to refer to a member of Linklaters LLP or an employee or consultant of Linklaters LLP or any of its affiliated firms or entities with equivalent standing and qualifications. A list of the names of the members of Linklaters LLP together with a list of those non-members who are designated as partners and their professional qualifications is open to inspection at its registered office, One Silk Street, London EC2Y 8HQ or on www.linklaters.com and such persons are either solicitors, registered foreign lawyers or European lawyers.
Please refer to www.linklaters.com/regulation for important information on our regulatory position.

We currently hold your contact details, which we use to send you newsletters such as this and for other marketing and business communications.

We use your contact details for our own internal purposes only. This information is available to our offices worldwide and to those of our associated firms.

If any of your details are incorrect or have recently changed, or if you no longer wish to receive this newsletter or other marketing communications, please let us know by emailing us at marketing.database@linklaters.com.

One Silk Street

London EC2Y 8HQ

Telephone (+44) 20 7456 2000
Facsimile (+44) 20 7456 2222

Linklaters.com