

JULY 2009

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 144 – INVESTMENT BANKING INSOLVENCY PANEL PROPOSALS

*Response to the May 2009 HM Treasury Consultation Document on developing
effective resolution arrangements for investment banks*

Financial
Markets
Law
Committee

c/o Bank of England
Threadneedle Street
London EC2R 8AH
www.fmlc.org

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 144 WORKING GROUP

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CONTENTS

1.	Introduction and Executive Summary	4
2.	Ensuring clarity and addressing misconceptions	7
3.	Improving transparency	8
4.	Improving speed of access	10
5.	Other views on the issue of client assets	15
6.	Orderly investment process	17
7.	Continuity of service obligations	17
8.	Changes to initiation process for insolvency	18
9.	Greater freedom for insolvency practitioners	19
10.	Special insolvency regime	21
11.	Special insolvency officeholders	22
12.	Other possible resolution tools	25

1. Introduction and Executive Summary

A) Introduction

- 1.1 In May 2009 HM Treasury issued a consultation document headed “Developing effective resolution arrangements for investment banks” (the “Consultation Document”). The Consultation Document discusses certain issues that were highlighted by the collapse of Lehman Brothers International (Europe) Limited (“LBIE”), including the treatment of monies and assets belonging to the bank’s clients and the open or unreconciled over-the-counter trading positions following the bank’s collapse. It also examines what can be done to make the process of insolvency itself more effective, and to limit the damage that may be done by a failing investment bank.
- 1.2 This paper focuses specifically on issues concerning the return of client monies and assets in the event of the commencement of insolvency proceedings of an investment bank and responds to the questions in the Consultation Document which are relevant to such issues (Questions 7, 8, 9, 11 and 18-24). Client assets, as referred to in this paper, are the financial instruments that belong to the clients of an investment firm and are held on their behalf by the firm in the course of its investment business. Similarly, client money is money that a firm holds for or on behalf of a client in the course of its investment business.
- 1.3 Clients have proprietary interests in client assets and money and they are distinct from the assets and money of the firm. There are therefore expectations that the failure of an investment firm should not substantially impact the return of such assets to the clients to whom they belong because they fall outside the general estate of the firm. Notwithstanding this, however, the clients of LBIE were unable to secure a prompt return of their assets from LBIE after the bank became insolvent.
- 1.4 The role of the Financial Markets Law Committee (the “FMLC”) is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed. This paper, therefore, does not comment on the many important policy issues raised in the Consultation Document which are relevant to the treatment of client monies and assets other than as necessary to deal with issues of potential uncertainty or misunderstanding.

B) Executive Summary

- 1.5 The trust law principles on which the existing client asset regime is based are capable of being used to create a clean, unchallengeable equitable title to assets held by a third party. The reason that this is very rarely done in practice is that the establishment of a system on this basis would involve the separate recording of assets in the name of individual clients at every level of the custody and sub-custody system and the elimination of all rights against such assets (including rights of use, set-off and lien). The cost of providing this

level of segregation is very high and, in practice, clients appear to have taken a commercial decision that the cost to them of requiring assets to be held in this way exceeded the benefit in terms of increased security on the insolvency of the counterparty.

- 1.6 Typically, the assets of an investor will be pooled with those of the investment firm's other customers and held in a global client account, and it is generally accepted that each of these customers will have a co-ownership interest in the pooled assets in the percentage that their claim bears to the aggregate pool. As a result, there is likely to be a period after the insolvency of the firm during which it is unclear how large the pool of client assets is and whether it will be sufficient to cover the entitlements of all investors. It is also common for the account to be held by a sub-custodian rather than the investment bank itself and, in such circumstances, it is customary for investment firms to grant sub-custodians a right of lien or set-off or other security interest over such assets in respect of its own indebtedness. Clients may therefore find that assets held by a sub-custodian will not be released to them until this other indebtedness is discharged and that, pending such discharge, they cannot obtain access to their assets.
- 1.7 There has also been much discussion of customers granting investment firms unfettered rights of use in respect of their assets. To the extent that assets are converted to use, or rehypothecated, the investment firm takes title to those assets and then transfers title to third parties under an arrangement which is functionally similar to a stock loan or "repo transaction". Provision is made for the return of the assets, but customers are exposed to the credit risk of the investment firm while the arrangement is in place. Not least because the third party may have rights of set-off, for example, against the insolvent broker or other continuing contractual claim.
- 1.8 Under the current law, where a director of a company is considering introducing a "breathing space" to allow an opportunity for consulting regulators and implementing an orderly transition into administration, he will be aware that he may face disqualification or a liability for wrongful trading. If he is deterred by this, the pre-insolvent entity may be deprived of its best chance for a well-ordered transition into administration. This is a particularly significant in the case of a complex investment firm and could result in unsettled trades which further complicate the release of client assets.
- 1.9 Accordingly, the FMLC's principal recommendations are as follows:
 - (a) Improved transparency and reporting would better enable investors to assess the extent to which their assets are secure, if they are informed of the jurisdictions of relevant sub-custodians, whether assets are held in an account segregated from the firm's own assets and whether client omnibus or client specific accounts are utilised, and the aggregate value of assets in respect of which a right of use has been exercised.
 - (b) In order for transparency to enhance client protection in practice, it is crucial that, post-insolvency, the operations and back office systems of the failed bank continue to operate through a complete reporting cycle in order

to reconcile the last record of the client's account with the unreported movements. To this end, the FMLC would propose that HM Government should consider what positive measures and/or legal sanctions may be appropriate to keep a failed bank's back office systems functioning after an insolvency, including measures to impose sanctions to deter the wilful destruction of trading records or shutting down of computer systems and the withholding of key information (such a passwords and system codes) in the immediate aftermath of a bank's collapse.

- (c) The failure by certain customers of LBIE to cap levels of rights of use or rehypothecation in the prime brokerage document or, indeed, to understand the implications of this, appears to have been a glaring omission and there has been some suggestion that this should be addressed through regulatory action. However, the FMLC is of the view that ensuring that hedge funds negotiate appropriate contracts with their brokers and custodians is something that is best dealt with by education initiatives through trade associations such as the Alternative Investment Management Association and the Hedge Fund Standards Board. If however any changes in this area are proposed, it is important that such changes are considered in the light of the whole legal and financial context, including the standard market practices of the repo market. The FMLC would suggest that to interfere with one practice without considering similar practices in the broader commercial context might introduce uncertainty and, potentially, distort the markets.
- (d) In order to address situations where a sub-custodian is entitled to refuse to release client assets until the indebtedness of the investment firm to the sub-custodian is discharged, there may be a case for the Financial Services Authority (the "FSA") to require investment firms to ensure that sub-custodians waive any rights of lien, set-off or security interest over assets recorded in a client account with respect to liabilities owed by the investment firm in a principal capacity.
- (e) A statutory cut-off date should be introduced in respect of claims for client assets held by an insolvent investment bank, provided that investors are given sufficient time to determine the existence of any claims they may have.
- (f) There may be a case for introducing a limited extension to the scope of the defence of a director of an investment bank against wrongful trading and disqualification as a director in circumstances where, after there is no reasonable prospect that insolvent liquidation will be avoided, he has acted with a view to achieving an orderly handover of the bank to an administrator and minimising market disruption in the interests of creditors as a whole.
- (g) It should be considered whether administrators ought to be provided with further protection through legislation since, under insolvency law as it stands, there may be incentives for administrators to seek to secure a high degree of confidence before releasing client assets. However, it is noted that, in significant appointments, an administrator may be able to negotiate

some form of contractual protection at the time of his appointment from the petitioning creditor (if applicable) or company to which he is being appointed. There are also numerous factors, other than concerns over personal financial liability, which would motivate administrators to be cautious in the exercise of their duties in relation to client assets, including reputational risk, professionalism and the great practical difficulties in unwinding the complexities of a bank's business.

- (h) A special insolvency regime for investment banks should not be introduced. This is largely because it is improbable that any expertise as to the operation of the regime would be able to develop before the regime is used for the first time and, given that this is unlikely to be for a number of years, the legal landscape and insolvency legislation may have evolved to the extent that the regime is no longer fit for purpose. As to whether a separate insolvency officeholder should be introduced to deal with the return of client assets, the FMLC acknowledges that this may bring certain important benefits, but it has yet to conclude its thinking on this question.

1.10 The FMLC notes that the Consultation Document relates to the insolvency of investment banks. It is essential, in the view of the FMLC, that any forthcoming proposals for an insolvency regime extend that regime to all prime brokers. In this regard, HM Government may wish to note that LBIE is not a "credit institution" but an "investment undertaking" which falls outside the Directive on the reorganization and winding-up of credit institutions.¹

2. Ensuring clarity and addressing misconceptions

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?

- 2.1 In the case of LBIE, misconceptions and lack of clarity around client assets and client money arose from two primary sources:
 - (a) A lack of understanding on the part of customers as to what the relevant client money and client assets rules said, what protections these rules provided and what protections they did not; and
 - (b) A lack of understanding on the part of customers as to the effect that the contractual terms with LBIE had on the protections that the client money and client assets rules would have otherwise conferred.
- 2.2 Greater clarity around the protections offered by the client money and client assets rules could be achieved by amending the CASS rules² to require firms to make explicit statements about the effect of the client money and client assets rules and the way in which they operate; for example, by explaining that clients

¹ 2001/24/EC

² See the Client Assets sourcebook in the FSA Handbook, which can be accessed via the following link: <http://fsahandbook.info/FSA/html/handbook/CASS>.

bear the risk of a secondary pooling event upon the failure of a bank or by making it clear that where the firm uses the “Alternative Approach”³ to segregate client money, that money will not be protected until the day after it is received. The current CASS rules do not require the inclusion of any specific language to this effect, although the FMLC understands that a number of the larger investment banks do include explanatory language in their standard prime brokerage documentation.

- 2.3 With regard to the terms of the prime brokerage agreements, a number of LBIE’s customers exposed themselves to significant risk by agreeing to the inclusion of unfettered rights of use, transfer of title or rehypothecation language. These contractual devices themselves are neither misleading, pernicious or unfair and, although they create risk for the customer where the amount of assets taken by the prime broker exceeds the customer’s debt to the prime broker, there is often a pricing benefit to the customer in allowing higher rates of use or rehypothecation and establishing an appropriate balance is a commercial matter as between customer and broker. Likewise, a number of clients had not negotiated termination and acceleration rights in their favour in the event that LBIE became insolvent.⁴
- 2.4 In hindsight, a failure to cap levels of use or rehypothecation, or a failure to negotiate mutual termination rights, appears to be a glaring omission and there has been some suggestion that this should be addressed through regulatory action. However, where customers are professionals and are advised by independent specialist legal counsel, the FMLC is of the view that ensuring that hedge funds negotiate appropriate contracts with their brokers and custodians is something that is best dealt with by education initiatives through trade associations such as the Alternative Investment Management Association and the Hedge Fund Standards Board. Both bodies currently publish a number of best practice guides and these could be amended to include appropriate discussion of key contractual terms in a prime brokerage agreement. As a final observation, it might be said that LBIE has, in fact, provided all the education that the market needed in relation to the effect of common contractual terms in prime brokerage agreements.

3. Improving transparency

Question 8: What are your views on how the Government can best address its objective of improving transparency by facilitating the identification and legal characterisation 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?

- 3.1 HM Government’s objective in securing greater transparency around the treatment of client assets and monies is sub-divided into three aspects:

³ For a description of the Alternative Approach, please refer to the FSA Handbook CASS 7; the term is defined in CASS 7.14.16.

⁴ For a discussion of the implications for LBIE’s customers of failing to negotiate mutual events of default, please refer to section 4.6 of this paper.

- (a) Resolving practical issues through better record keeping and reporting;
 - (b) Providing information around the segregation and rehypothecation of assets; and
 - (c) Establishing legal clarity as to the basis on which assets are held.
- 3.2 The FMLC agrees with HM Government's conclusions in paragraph 3.55 of the Consultation Document that "English trust law under which client assets and monies are held is well established and, in most cases, clear" and, in paragraph 3.56, that "...the problems experienced in Lehman Brothers' insolvency do not appear to have any substantial roots in legal uncertainty".
- 3.3 However, the protection given to clients by trust law is fragile. If trust property cannot be identified with certainty, the trust with respect to that property will likely fail, in which case, client assets may either form part of the insolvent entity's estate available to its general creditors, or be commingled with other trust property and so subject to competing claims from other holders of proprietary interests.
- 3.4 Whilst improved transparency may go some way towards addressing this issue, it is important to realise that any scheme to improve transparency is subject to significant practical limitations. In particular, reports of customers' accounts that set out the securities credited to that account, securities subject to rehypothecation and valuations of different trading positions and derivatives as between the bank and its client will be historic in nature. In any period, each of the entries in the account will vary as new trades are entered into and terminated, securities are purchased and sold, settlements occur or fail, the level of funding given to a client reduces or increases, the right to rehypothecate assets is exercised or rehypothecated assets are returned, currency fluctuations cause the value of different positions to vary and the mark-to-market on derivatives fluctuates. As a result, the actual position on a customer's account may vary materially in a very short period of time following each report; in particular, at a time of market stress that is likely to accompany the failure of a prime broker. The variations in scope and individual complexities of this relationship, in the FMLC's opinion, argue against the use of prescriptive regulations as a means to ensure transparency on grounds of legal certainty alone. There are also, no doubt, practical and commercial arguments that support this view.
- 3.5 However, in order for transparency to enhance client protection in practice, it is crucial that, post-insolvency, the operations and back office systems of the failed bank continue to operate through a complete reporting cycle in order to reconcile the last record of the client's account with the unreported movements. To this end, the FMLC would propose that HM Government should consider what positive measures and/or legal sanctions may be appropriate to keep a failed bank's back office systems functioning after an insolvency, including measures to impose sanctions to deter the wilful destruction of trading records or shutting down of computer systems and the withholding of key information (such a passwords and system codes) in the immediate aftermath of a bank's collapse.

4. Improving speed of access

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?

- 4.1 As a preliminary point, it should be emphasised that the trust law principles on which the existing client asset regime is based are capable of being used to create a clean, unchallengeable equitable title to assets held by a third party. The reason that this is not always done (in fact, is almost never done) is that the establishment of a system on this basis would involve the separate recording of assets in the name of individual clients at every level of the custody and sub-custody system and the elimination of all rights against such assets (including rights of use, set-off and lien). The cost of providing this level of segregation is very high and, in practice, clients appear to have taken a commercial decision that the cost to them of requiring assets to be held in this way exceeded the benefit in terms of increased security on the insolvency of the counterparty.
- 4.2 It may well be that this view was based on an inaccurate estimation of the likelihood of failure, and the FMLC is aware that firms are currently restructuring their offerings in this area in order to increase the levels of protection offered against this risk. However, the view of some FMLC Members is that the question of whether this risk should be capable of being taken by firms and customers is a commercial one for them. The basis for mandating any particular standard of protection in this inter-professional market has not been made clear.
- 4.3 Where an investor is able to establish an uncontested claim to assets held on trust, his access to those assets will be immediate but, as stated above, an unchallengeable equitable title to assets is rarely achieved by investors in practice. The factors which may constitute bars to an investor obtaining his assets immediately can, in general, be categorised as follows:
- (a) Other persons - notably other customers - may also have claims on the assets identified;
 - (b) There is an existing counter-claim against the assets which takes precedence over the claims of the client; and
 - (c) The claims of the client are restricted by other claims arising between him and the firm.

Each of these is considered in turn.

- 4.4 *“Other persons - notably other customers - may also have claims on the assets identified”*

In general this bar becomes an issue when the investor has inadequate information at the outset as to his own and other customers’ rights, whether the latter are other customers for custody services or, more generally, creditors and

other counterparties. However, the issue is not capable of being completely resolved through disclosure, contractual certainty, record keeping and transparency improvements. As was demonstrated in the *Global Trader* case,⁵ ambiguities may still arise upon the broker's insolvency as to the extent of and validity of various claims on client asset accounts. In these cases, there will therefore be a necessary lapse of time before different customers' entitlements can be established, if necessary by the courts.

In particular, in such cases the uncertainty that arises manifests as a doubt as to which assets are properly treated as client assets and which as belonging to the estate of the failed firm. This means that it is unclear (i) which assets are to be returned to clients and which are reserved to satisfy the claims of other customers *qua* general creditors, and (ii) how large the pool of client assets is and whether it will be sufficient to cover the entitlements of all investors with a proprietary claim. The question is how the length of this period may be minimised. This may be achieved, in part, by the introduction of a special insolvency officeholder to identify client monies and assets and facilitate their return to clients as quickly as possible; further consideration of this proposal is contained in section 12 below.

4.5 *"There is an existing counter-claim against the assets which takes precedence over the claim of the client"*

There are two primary sub-divisions of claims which may arise here: (i) claims of sub-custodians, and (ii) claims of parties to whom property has been rehypothecated.

(a) Sub-custodians

Client assets are frequently held with sub-custodians. Sub-custody accounts are almost invariably operated by the primary custodian on a pooled basis, and are likely to be subject to a lien in respect of indebtedness of the primary custodian to the sub-custodian. Clients may therefore find that assets held by a sub-custodian will not be released to them until other indebtedness is discharged and that, pending such discharge, they cannot obtain access to their assets.

This raises the issue as to whether the FSA should require investment firms to ensure that sub-custodians waive any security interest, lien or right of set-off (to the extent permitted by law) over assets recorded in a client account with respect to liabilities owed by the investment firm in a principal capacity. Those jurisdictions where this is not achievable could be clearly identified to clients. On the one hand, this would provide greater protection for clients and improve their chances of recovering their assets in the event of their custodian's or broker's insolvency. On the other hand, it can be argued that an investment firm which offers a custody business as part of its operations should be able to protect itself from credit risk to its clients via fundamental credit protection tools such as set-off. Not only is this important from an individual firm perspective, it is also important from a systemic perspective.

⁵ *Re Global Trader Europe Limited (in liquidation)* (24 March 2009)

One possible solution to the regulatory dilemma is to encourage the maintenance of segregated accounts at the sub-custody level. However, for the reasons set out in section 4.1 above, segregated accounts for each client would create additional settlement complexity requiring specific account details per client to be provided by executing brokers, and would incur significant cost. It is also true to say that there may be additional operational risks involved in a system which depends on the accurate transmission of so much client-specific data between institutions, whilst the advantages in a solvent trading context would be nil.

Where enhancements could efficiently be made, as the Consultation Document identifies, is around transparency and reporting. Reporting to clients by the investment firm by jurisdiction of its sub-custodians and the securities holding pattern utilised in such jurisdictions, including whether assets are held in an account segregated from the firm's own assets and whether client omnibus or client specific accounts are utilised, should assist the process of reconciling customers' positions upon a custodian's insolvency.

(b) Rehypothecation ("right of use")

Most investment firms run their prime brokerage businesses as self-funding operations. They depend, therefore, on the ability to secure financing for the leverage provided to clients by utilising their assets. As a result, client assets are frequently converted to use by prime brokers who, under contract, take title to those assets and then transfer title to third parties under an arrangement which is functionally similar to a stock loan or "repo transaction". Provision is made for the return of the assets but clients are exposed to the credit risk of the broker while the arrangement is in place. Not least because the third party may have rights of set-off, for example, against the insolvent broker or other continuing contractual claim.

Under a repo transaction, the seller of the securities receives financing via the purchase price paid by the purchaser (the amount of which reflects the "haircut" applied to the purchased securities) and then any mark-to-market fluctuations are separately collateralised. In the case of rehypothecation, the prime broker takes title to certain of the client's securities and uses those securities to generate the funding which it uses, in turn, to extend leverage to its prime brokerage clients. The credit risk, discussed above, which this use of assets may create for the fund can be limited by the restriction on the amount of assets which can be used by the prime broker, which is typically agreed as a percentage of the fund's net liabilities to the prime broker (often 140 per cent.). Thus the client is in the same position whether his financing has extended under a repo transaction or it has been given subject to a right of use over his assets.⁶

The UK's approach to date has been to treat rehypothecation as a matter of commercial negotiation between investment firms and their customers. The

⁶ Subject only to the "haircut" on the repo compared to the percentage limit on the right of use.

suggestion that this approach ought to change must be considered in the light of the whole legal and financial context, including the standard market practices of the repo market. The FMLC suggests that to interfere with one practice without considering similar practices in the broader commercial context might introduce uncertainty and, potentially, distort the markets.

Undoubtedly, there is merit in improving transparency around the right of use. As suggested in the Consultation Document, these requirements could include the provision of daily reporting of the aggregate value of assets utilised under a right of use and the amount at a CUSIP level;⁷ and clarity as to the exposures which are taken into account in determining the net liabilities against which any rehypothecation limit is set (with the rehypothecation limit percentage remaining freely negotiable).

4.6 *“The claims of the client are restricted by other claims arising between him and the firm”*

Restrictions upon the claims of clients which ultimately derive from the overall commercial context of the client-broker relationship have been prevalent in the administration of LBIE. For example, it appears likely that the administrators of LBIE will take a point on the interpretation of the close-out netting clause in the LBIE prime brokerage agreement which, if successful, will permit *inter alia* the conversion of long client assets (still held in custody and not rehypothecated) into a cash value to be set off against liabilities owed by the client. This process would restrict the ability of the client to assert a proprietary entitlement to his assets in custody and, indeed, would entirely annul his entitlement to the converted assets. This interpretation has yet to be considered by the courts. However, concern on this point can be met in future by a change in drafting practice (if indeed other prime brokerage agreements contain a similar clause). A close-out netting clause drafted to meet this concern would include a positive statement that client securities which were not subject to use at the time of the investment firm or client default are not to be included in the netting calculation. This would ensure that the overall objective of the protections conferred by the FSA’s client assets rules is achieved without the need for additional legislation or regulation.

As a corollary to concerns about the use of client assets for set-off purposes by the insolvent firm’s administrator, it appears that clients may be disadvantaged by a failure to provide contractually for an event of default by their prime broker. Many of LBIE’s customers did not negotiate mutual events of default and set-off and now cannot take advantage thereof themselves. Had such rights been negotiated then, with or without a successful assertion of a proprietary entitlement, many clients would have found themselves in a much less awkward position vis-a-vis the administration. For example, customers would not have had to repay margin debt in full but would have had the benefit of being able to reduce such amount by setting off the value of any assets rehypothecated.

⁷ CUSIP refers to the Committee on Uniform Security Identification Procedures and the 9-character alphanumeric security identifiers that they distribute for securities for the purposes of facilitating clearing and settlement of trades.

Both these concerns are almost certainly best addressed by the market, through the negotiation of appropriate contractual terms between client and broker. The raised awareness among clients about the possibility of an insolvency on the part of a prime broker, brought about by the LBIE collapse, will facilitate this solution. Legislative or regulatory intervention would probably only increase legal uncertainty: regulating to limit the way in which a firm deals with client assets does not always guarantee a clear outcome upon the firm's insolvency, as demonstrated by the *Global Trader* case, and legislating for a particular set-off arrangement upon the firm's insolvency by overriding the parties' own contractual arrangements would also cause confusion.

- 4.7 There are, in addition, some potential changes in current insolvency law which, if implemented, could improve the flexibility of the market.
- (a) Ring-fencing of sub-accounts and sub-asset pools

In broad terms, the FMLC proposes that a legal mechanism should be provided which increases flexibility with regard to the ring-fencing of client money. Different business activities carry different risks and may require client money to be held in different locations. Therefore, consideration should be given to whether firms should have the ability to ring-fence different pools of client money in the event of a primary pooling event. For example a firm may want to ring-fence its listed derivatives business from other areas under a separate calculation with separate bank accounts. This would allow for risks to be contained within a client base which has signed up to those risks and should allow for more vanilla client money balances to be returned to clients in a timely manner. Under the current client money distribution rules, all client money is pooled in the event of the failure of the investment firm.

- (b) Accelerating the process by including a cut-off date for client claims

Although the superiority of a proprietary entitlement over a personal right may depend in part on the idea of its being permanently vindicable, the establishment of a "bar date" by which clients claiming a proprietary interest in assets held by an investment firm are required to have lodged their claim appears to be something to which there is no satisfactory practical alternative, given the need to ensure that the reconciliation of claims is brought to a swift conclusion. Indeed, under the SIPC liquidation process in the United States,⁸ a customer of an insolvent brokerage firm which is a SIPC member must submit a claim form in respect of his cash and/or securities held with that firm before a specified deadline. If the customer fails to do so, he will risk not recovering his investments, but the inclusion of a bar date in these circumstances does not appear to have caused any customer disquiet.

Under current UK administration rules, a cut-off date can only be achieved via a scheme or arrangement. It is at least debatable whether a scheme of arrangement is an appropriate vehicle for the treatment of client assets, which

⁸ The Securities Investor Protection Corporation (SIPC) is a non-profit, non-government, membership corporation, funded by member dealer-brokers. Its primary role is to return funds and securities to investors if the broker-dealer holding these assets becomes insolvent.

are (usually) held under a trust, and it seems likely that the courts will be asked to consider precisely this question in the near future. The introduction of a statutory cut-off date in respect of claims for client assets held by an insolvent investment bank, which is independent of the provision for a scheme of arrangement among creditors, appears, therefore, to be a viable proposal, provided that investors are given sufficient time to determine the existence of any claims they may have.

5. Other views on the issue of client assets

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?

- 5.1 The FMLC feels that the Government should consider, in particular, the following three issues.
- (a) Segregation: breach of contract/regulation by investment firm
- 5.2 Consideration should be given to what happens when the investment firm fails to comply with its obligations in relation to client monies and assets (whether contractual or regulatory) and to consider back-up default rules to address these situations. For example, if an investment firm is obliged to segregate monies or assets for a particular client but fails to do so in practice, then it is likely that, as English law currently stands, that client will have only an unsecured claim (or at best, and completely fact-dependent, a possible tracing claim) against the insolvent investment firm.
- 5.3 A client that has a regulatory or contractual right to segregation will form a reasonable expectation that its assets have been segregated and are, therefore, protected on the insolvency of the investment firm. *Prima facie*, it seems counter-intuitive that the client in question should then find itself in the same position as a client that had agreed upfront that its assets would not be segregated. It is possible that the answer to this conundrum lies simply in the limitations of regulation, which does not confer private rights, and in the way in which insolvency law necessarily trumps the outcomes which the parties have provided for under contract. However, the FMLC believes that a reasoned consideration of this issue, in the context of HM Government's further work in this area, would be of benefit. The FMLC understands that other respondents to this consultation will argue that, as a policy matter, in the case of the client with a contractual right to segregation, that the client's trust property be "topped up" from the general estate to the value of any assets that the firm should have segregated for that client (on the grounds that, absent such a top up, it would be the general estate that would benefit from the assets that should have been segregated by the investment firm for that particular client). However, the FMLC offers no opinion on this policy matter.
- 5.4 It is noted that topping up from the general estate is one of the many issues to be considered by the court in the directions hearings in respect of client money issues in the LBIE administration. As part of these hearings, it is likely that the *Global Trader* decision will be challenged by certain creditors. Self-

evidently, unless *Global Trader* is overturned, such a top-up obligation would need to be imposed by legislation or regulation.

(b) Uncertainties in relation to global client accounts

- 5.5 Although the generally accepted market view is that, where client assets are segregated in a global client account, each client has a *pro rata* co-ownership share in that pool of assets (as tenant-in-common or joint tenant), the case law is not entirely clear on this point. Whilst there are a few authorities in support of this view, a number of cases do not support the co-ownership analysis.⁹
- 5.6 There are also legal uncertainties about how any shortfalls in an omnibus client account should be apportioned. Whilst the market generally accepts that shortfalls on such accounts will be borne *pro rata* by clients in accordance with their percentage holdings, in the absence of express agreement with each affected client to that effect, if a court were to apply the complex equitable rules regarding tracing, a different result might actually be reached. The market could address this uncertainty with improved clarity in documentation, but this would arguably need to be consistent across all clients with a claim to assets held in any global client account. There may also therefore be a case for regulatory or statutory clarification.
- 5.7 However, these uncertainties should be clarified by future EU legislation on legal certainty of securities holding and dispositions, which was the subject of a recent consultation paper,¹⁰ and by the UNIDROIT Draft Convention on Substantive Rules Regarding Intermediated Securities (September 2008), if this Convention is ratified by the European Commission.

(c) Uncertainties in relation to rehypothecation

- 5.8 It is generally accepted that, where a right of rehypothecation or a right of use has been exercised, the client will have no proprietary interest in respect of assets that are no longer in the client account. However, legal uncertainties still exist in situations where (i) the investment firm's rights of rehypothecation have been exercised, but equivalent securities have been returned to the client account; and (ii) the investment firm has rehypothecated assets in excess of any applicable rehypothecation limits for a particular client.
- 5.9 In the first scenario, the market consensus, which underpins current practice, is that the client will have a proprietary interest to the extent of the returned securities. However, it is not entirely clear from case law that the trust that was applicable to the original securities prior to rehypothecation "springs back" over the returned securities. The concern is that, notwithstanding the wide market assumption of a proprietary interest in returned securities, an

⁹ For examples of cases that support the view that clients have a *pro rata* co-ownership share in assets held in a global client account, see: *Hunter v Moss* [1993] 1 WLR 934; *Re Stapylton Fletcher Ltd* [1995] 1 All ER 192; *Re Harvard Securities* [1997] 2 BCLC 369. For examples of cases which do not support the co-ownership analysis, see: *Re London Wine Co* (1986) PCC 121; *Re Goldcorp Exchange Limited* [1994] CLC 591; and *CA Pacific Finance* [1999] 2 HKLRD 1 (Hong Kong).

¹⁰ G2/PP D (2009)

insolvency officeholder would not feel comfortable returning such assets to clients in the absence of directions from the court on this issue.

- 5.10 In the second scenario, it is clear that where rehypothecated assets (even those rehypothecated by the investment firm in breach of any applicable rehypothecation limit) are in the hands of *bona fide* third party purchasers for value without notice, the proprietary claim of the client in those assets is likely to be terminated. However, where those assets remain in the possession of the investment firm (in its house account or otherwise), questions are likely to arise as to whether the client may retain a proprietary interest in, or tracing claim to, those assets or proceeds of the same. The answer to these questions will depend in large part on the particular fact pattern that emerges. HM Government will be asked to consider whether any special provision is required in the case of an investment firm that has rehypothecated assets in excess of an applicable contractual limit (and particularly where those assets remain in the investment firm's possession). For example, the FMLC understands that other respondents will argue that it would be reasonable to require the investment firm to top up the relevant client's trust property from the general estate (as it is the general estate that has taken the benefit of that right of use). However, the FMLC offers no opinion on this proposal.

6. Orderly investment process

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

- 6.1 The views of the FMLC on the proposals outlined in paragraph 4.32 of the Consultation Document are set out below.

7. Continuity of service obligations

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

- 7.1 It may be helpful to give the administrators of an insolvent investment bank express powers to take whatever steps are required to ensure the continued functioning of its IT and other systems, but it would be difficult to impose an obligation on administrators to do so. They might well be unable, as a practical matter, to fulfil such an obligation. As recognised in the Consultation Document, IT and other functions may be organised through separate legal entities within a group (or through outsourced service providers) which may be located in different countries. The investment bank may have no more than a licence to use a system, which licence is terminable in the event of its insolvency. Furthermore, the service provider may be in a position to extract a substantially increased fee in return for agreeing to continue the service.
- 7.2 Market and regulatory action appears to offer the principal means of ensuring that arrangements are organised so that, in the event of an investment bank's

insolvency, an administrator would be able to continue to operate such systems. It might be possible to impose by statute an obligation on a provider of IT services to continue those services if requested by the administrator of an investment bank (subject to the administrator paying for them), at least for a minimum period of time, but this would be difficult to enforce where the service provider is based in another jurisdiction or the relevant contract is not governed by English law. Legislation cannot by itself, therefore, solve this problem.

8. Changes to initiation process for insolvency

Question 20: What are your views on possible changes that could be made to the incentives around the initiation of insolvency proceedings?

- 8.1 The FMLC agrees with the statement made in the Consultation Document that directors of a company are strongly incentivised to commence formal insolvency proceedings as soon as they become aware that the company is unlikely to avoid insolvent liquidation. Under the Insolvency Act 1986, if a company has gone into insolvent liquidation and, at some time before the commencement of the winding up, a director of the company knew or ought to have concluded that there was no reasonable prospect that this would be avoided, a court may declare that director personally liable to make a contribution to the company's assets.¹¹ There is, however, a defence available to the director against such a declaration if he is able to show to the satisfaction of the court that, after he knew or ought to have concluded that insolvent liquidation would not be avoided, he took every step with a view to minimising the potential loss to the company's creditors that he ought to have taken.¹²
- 8.2 The threat of personal liability may, as the Consultation Document suggests, operate against the wider interest of creditors themselves (and the public interest in terms of financial stability) in having a longer handover to administrators in the case of some complex or systematically important firms. There is also a strong argument that directors of an investment bank should not, in principle, be penalised for facilitating a "breathing space" to allow an opportunity for consulting regulators and others and implementing an orderly transition into administration. The FMLC considers that there may, therefore, be a case for extending the scope of the director's defence against a declaration that he is personally liable to contribute to the assets of an insolvent company, such that a declaration could not be made against a director of an investment bank where that director had acted with a view to achieving an orderly handover of the bank to an administrator and minimising market disruption in the interests of creditors as a whole. Any such amendment would, however, require careful consideration.
- 8.3 If the scope of a director's defence against wrongful trading were extended in this way, there would have to be introduced, at the same time, an equivalent

¹¹ Insolvency Act 1986, ss214(1) and (2)

¹² Insolvency Act 1986, ss214(3)

defence for a director of an investment bank against actions for fraudulent trading and disqualification as a director.¹³

- 8.4 It would be possible to organise a "breathing space" only if the investment bank had access to sufficient liquidity to enable it to meet essential expenses during this period. The FMLC understands that it became necessary for LBIE to enter into administration at extremely short notice because its surplus cash had been transferred to another group company under group cash management (repo) arrangements without it receiving collateral in return. It is assumed that the question of how to preserve sufficient liquidity in an investment bank (or its UK branch) will be considered separately as a regulatory issue.

9. Greater freedom for insolvency practitioners

Question 21: What are your views on reducing or amending arrangements concerning liability for insolvency practitioners?

- 9.1 It is worth noting at the outset that the law is not entirely clear as to whether an administrator has the power to deal with trust property. As discussed above, since client assets are held on trust by the investment firm on behalf of the client, they are not *prima facie* the company's property and therefore such assets do not form part of the property of the company in respect of which an administrator is otherwise appointed. On the other hand, case law and practice suggest that an administrator may have some form of power to deal with trust property. Given these uncertainties, a statutory power expressly permitting administrators to deal with client assets in the case of investment banks is likely to be useful.
- 9.2 As to protection from possible personal liability, there are various types of protection from which an administrator may already benefit.
- 9.3 In significant appointments (including over investment banks), an administrator may be able to negotiate some form of contractual protection prior to or at the time of his appointment by way of indemnity from the petitioning creditor (if any) or from the company to which he is being appointed. The scope of any such indemnity would vary with each appointment on a case by case basis and will typically include a number of carve-outs, including for fraud and gross negligence.
- 9.4 An administrator will also have the benefit of the statutory discharge from liability when his appointment as administrator ceases under the Insolvency Act 1986 (the "Statutory Discharge"). However, the uncertainty as to whether or not dealing with trust property falls within the administrator's strict remit also leads to uncertainty as to whether, in respect of work undertaken concerning client assets, an administrator would have the benefit of the Statutory Discharge.

¹³ See Insolvency Act 1986, ss213 (Fraudulent Trading); and Company Directors Disqualification Act 1986.

- 9.5 In light of this uncertainty and since any contractual protection is the subject of individual negotiation (and may not always be available), any protection (or further protection) for officeholders would have to be given through legislation. At the very least, there is a case for clarifying that the Statutory Discharge applies equally to any role or responsibility for client assets.
- 9.6 It would, of course, be possible to provide administrators with additional safeguards over and above the foregoing and there is no doubt that administrators would welcome any additional protection that is offered them. Certainly, any such additional protection could not slow down the process of administration (including dealing with client assets) and may assist in speeding the process up a little.
- 9.7 However, there must be real doubt as to whether it is the fear of litigation that primarily prevents administrators from returning client assets sooner and, therefore, whether offering administrators further protection would achieve a speedier resolution of the issues affecting client assets. Indeed, in addition to any concerns over personal financial liability, there are numerous other factors that motivate administrators to be cautious in the exercise of their duties in relation to client assets. Without purporting to be in any way exhaustive, some of the more significant factors will include:

Professionalism: an administrator is an officer of the court, a professional and, most likely, a partner at one of the leading city accountancy firms. An administrator (certainly one who has reached the point in his career where he is appointed as an administrator of an insolvent investment bank) will inevitably be a careful, thorough and professional individual who will not naturally be inclined to take short-cuts, particularly in relation to trust property, regardless of any risk of personal financial liability.

Reputation: Whether or not he can be sued, any administrator will be concerned about his reputation and his next appointment and will not rush to distribute assets in circumstances where it may later transpire that he has been wrong to do so.

Practicalities: In the case of LBIE, insolvency intervened at short notice and the administrators were provided with little or no time to prepare for the administration process. It is likely that the single most important reason why so many client assets have not yet been returned to clients is due to the great difficulty in unwinding the complexities of the bank's business. It is very doubtful that any further limitation of the administrators' personal liability would have led to any faster resolution of these complex issues in this case.

- 9.8 In light of the foregoing, whilst any administrator would certainly welcome any statutory protection on offer, and any such protection may help a little, it is doubtful whether it would make any substantial difference to the ability of an administrator of an investment bank to return client assets more promptly.
- 9.9 The FMLC would suggest that, if it is decided to reduce or amend the potential liability of an administrator, this be limited to cases where the administration relates to an investment bank or investment

firm holding client assets or money. In other cases, the responsibilities of the administrator should remain unchanged. Similarly, if it is decided to appoint a special insolvency officeholder to deal with client assets and monies, it may be appropriate for any change to potential liability to be limited to that officeholder alone.

10. Special insolvency regime

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

- 10.1 A number of special insolvency regimes already exist, most notably the recent provisions in the Banking Act 2009 for banks and other deposit-taking institutions. The introduction of another complex regime for dealing with investment banks would likely cause confusion to market participants and create legal uncertainty as to which regime applies where, for example, an institution conducts both investment and retail banking activities.
- 10.2 In addition, any special insolvency regime for investment banks would be used very rarely. Large financial institutions do not fail with every instance of recession or fluctuation of the economic cycle. Indeed, it is very unlikely that any special insolvency regime instituted now would be used in anger for a considerable period of time, perhaps ten or twenty years hence or perhaps even later. By then, the legal landscape and insolvency legislation and policy is likely to have evolved considerably. Unless any special insolvency regime for investment banks is assiduously kept up-to-date through the "boom" years (when it will not necessarily be uppermost in the legislator's mind) and through minor recessions, there is a real risk that it will not be fit for purpose when required.
- 10.3 Most importantly, experience tells us that in order for legislation to work smoothly and effectively, years of practice and the building up of a body of case law is needed. If the special insolvency regime for investment banks is to be used as rarely as can be hoped (if not expected), it is unlikely that such practice and case law will have the opportunity to develop.
- 10.4 A real life example of these difficulties can be found in the Greater London Authority Act 1999 (the "GLAA") which contains a special insolvency regime for Public Private Partnerships ("PPP") companies. Two PPP companies recently placed in PPP administration in accordance with the GLAA were the companies responsible for the infrastructure, maintenance and renewal business of London Underground, namely, Metronet Rail BCV Limited and Metronet Rail SSL Limited ("Metronet").
- 10.5 By the time Metronet was placed in PPP administration in July 2007, the GLAA itself was in force, but the PPP Rules were not. In the four year period before the PPP administration regime was used, no case law or practice had developed in relation to how the legislation should be applied, with the result that numerous applications had to be made to the court for clarification as to how the GLAA should be interpreted, leading to considerable expense for the

estate. In the six years since the GLAA came into effect, no other PPP administrations have occurred.

- 10.6 Whilst there may well be sectors in which a special insolvency regime may be necessary or desirable notwithstanding the difficulties described above (for example in relation to vital infrastructure where consumers are dependent on a single supplier, such that provision needs to be made for the immediate transfer of services to another supplier in order to avoid interruption of service), it is doubtful that investment banks fall into this category.
- 10.7 Instead, consideration should be given to making such refinements to the existing administration regime which may be required to create the flexibility needed to deal with specific issues affecting investment banks.

11. Special insolvency officeholders

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

- 11.1 There is an inherent conflict between the competing objectives faced by the insolvency professional in the context of an administration or insolvency of a firm holding client assets, namely those of (i) maximising returns of general creditors, and (ii) facilitating the swift return of customer property. This is particularly the case where the customer property is encumbered by way of security interest in favour of the insolvent firm to secure debts of the customer to the firm.
- 11.2 The tools currently available to insolvency practitioners under existing laws are tools designed solely to deal with creditor claims. As previously stated, claims for the return of client assets are trust claims which do not naturally fall to be treated as creditor claims and any attempt to do so by converting them into cash-equivalent claims undermines fundamental principals of trust law. However, whilst trust claims should not be treated as creditor claims, the claimants of client assets in the insolvency of an investment bank will often be debtors to the insolvent bank, with their debt to the bank being secured, in whole or in part, by the client assets to which they have a trust claim. This being the case, claims for the return of encumbered client assets must be considered in conjunction with any debt of the customer to the insolvent firm in order to avoid unfairly disadvantaging the unsecured creditors.
- 11.3 The FMLC is supportive of the development of new tools within the insolvency armoury to deal with claims for the return of client assets as a priority within an investment bank administration or insolvency to the extent that any new mechanism does not materially disadvantage other creditors. It has not yet, however, formed a view as to whether the prioritisation of the return of client assets would be best undertaken either (i) as an additional or overriding aim of an officer within the existing administration framework, or (ii) by a newly created special insolvency officeholder outside the

administration process. There are good arguments for and against each of the two propositions.

(a) Maintaining existing administration framework

Arguments for: keeping the responsibility for the distribution of client assets within the existing administration framework is likely to reduce the potential for disputes between those dealing with the general estate and those dealing with client assets, who might have competing claims over the same assets. In addition, any person charged with distributing client assets will require access to information and this will flow more freely within a single body.

Arguments against: there is a significant potential conflict between customer asset claimants and general creditors. If one firm is responsible for both, it occurs to the FMLC, without in any way wishing to question the undoubted integrity of licensed insolvency practitioners, that the administrator may find this conflict of duties difficult to manage optimally. Moreover, concern as to how to resolve this conflict may even create delay and inhibit the administrator from taking difficult decisions.

(b) Special Insolvency Officeholder

Arguments for: a separate officeholder will have a single priority and will not be conflicted by duties to general creditors; nor will the person responsible be concerned about his responsibility as a partner of the same accountancy firm as the general administrator. Where responsibility for the return of client assets resides outside the general administration, this also allows the administrator to devote all of his energies to maximising returns for general creditors without worrying about complex client assets issues.

Arguments against: unless the rights of a separate insolvency officeholder are very clearly defined and he is given a significant degree of primacy over the general administration in his ability to deal with customer asset claims and their associated debts to the estate, there is a high likelihood of protracted dispute and litigation with the administrator and higher costs.

11.4 The FMLC also notes the proposal described in paragraphs 4.58 to 4.60 of the Consultation Document and believes that this proposal could be made to work in the context of an investment bank insolvency. As the FMLC understands it, the proposal is that a client assets insolvency officer would be able to make a distribution of assets to customers based on a net consideration of both a customer's debts to the insolvent firm and the amount of assets held by firm for the customer. There are several issues that need to be addressed if such a scheme is to be successful and these are considered below.

(a) Firm Record Keeping

In order to allow a client asset insolvency officer to make a net distribution, firms would need to be required to keep track of the major exposures secured by customers on a daily basis so that the officeholder is able immediately to understand each customer's net position.

(b) Certainty/Reasonable pre-estimate

Any record keeping by firms of net exposures would, as discussed in section 3 of this paper, be subject to certain practical limitations. Such record keeping may not always be complete and where complex transactions are involved, may contain valuations used by the firm which customers have a legitimate right to challenge. In other words, it is unlikely that any net distribution will be entirely accurate in terms of exposures and values and will, in fact, be more akin to a reasonable pre-estimate of the parties' positions.

However, if the special officeholder were able to make a net distribution based on such a reasonable pre-estimate, without necessarily extinguishing the customer's or indeed the administrator's right to "true-up" or challenge the calculation at a later date, then client assets could be returned very quickly without materially disadvantaging unsecured creditors. To the extent that a subsequent true-up meant that the customer owed the insolvent firm an additional payment, the right of the estate to seek payment would not have disappeared. It would, rather, have changed in nature from a claim which was "secured" in some way by the administrator's right to retain the customer's assets against full payment, into an unsecured cash claim. This does not, however, seem unreasonable when considered in the context of the competing priorities of, on the one hand, the need to ensure that general creditors are not disadvantaged and, on the other, the need to maintain market confidence and liquidity by returning client assets which are unlikely to be required to discharge debts of the customer to the estate.

(c) Shortfalls

There are likely to be shortfalls or segregation deficits in any insolvent investment bank's holdings of client assets. Ensuring that firms keep better records of existing shortfalls would be helpful, but if client assets are to be distributed quickly then it may not be possible to ascertain the exact extent of the shortfalls before distributions start to be made.

(d) Liability

There is a case to be made for the proposition that, in order to avoid delays and inertia, a special insolvency officeholder would need to be able to make the net distributions referred to above without any personal liability, provided that he had acted in good faith based on the records kept by the firm. However, close consideration also needs to be given to the argument that the potential personal liability of officeholders does not increase delays. A fuller discussion of this issue can be found in section 9 of this paper.

(e) Interaction with other insolvency practitioners

Any interim determination of the net position of a customer and insolvent firm necessarily requires the consideration of debts to and from the estate, which are normally within the remit of the ordinary insolvency practitioners. This being the case, the special insolvency officeholder would need to be able to

make the distribution of client assets free from interference from the ordinary insolvency officeholders and without any need to obtain their consent.

(f) Appointment, Powers and Expenses

If it were decided to create a special officeholder, it would be necessary to consider by whom he would be appointed, what powers he could exercise, what reporting duties he would have and out of what assets his remuneration and expenses would be paid. These questions would require further consultation.

12. Other possible resolution tools

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?

- 12.1 There is one further idea which might merit consideration. Generally, a debtor to a company may purchase a debt against the company and set it off against the company's claim on him. However, in any administration or liquidation, a debtor is prevented from improving his position in relation to other creditors by buying claims against the company after notice of an insolvency related event.¹⁴ Rule 2.85(2)(e) of the Insolvency Rules 1986 excludes from administration set-off any debt acquired by a creditor by assignment or otherwise, pursuant to an agreement between the creditor and any other party, where that agreement was entered into after a specified cut-off time. A similar exclusion applies in a winding up under Rule 4.90(2)(d), subject to different cut-off times.
- 12.2 It may be useful to give discretion to a court to disapply these restrictions as part of a scheme of arrangement which includes a framework permitting creditors of an insolvent investment bank to sell their claims to other creditors on a basis which achieves the necessary degree of fairness between creditors. Further consultation may be necessary to evaluate whether the existence of such a power could in itself be a source of uncertainty.

¹⁴ See Goode on Legal Problems of Credit and Security, Fourth Edition, paragraph 7.90.

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