Feature

KEY POINTS

- For administrators and their advisers successfully to steer a financial institution through special administration and achieve a fair and timely outcome for clients and creditors alike they will need to consider the rules and guidance in the new draft special administration regulations in combination with the proposed amendments to the FCA's Client Assets Sourcebook (CASS) and the guidance set out in the judgments in the Lehman Brothers and MF Global litigation.
- Draft regulations seek to prevent arbitrage by clients with alternative claims that would result in detriment to the generality of clients and creditors.
- The Financial Conduct Authority (FCA) proposes a limited extension of the operation of the hindsight principle in CASS.

Author Sarah Bayliss

Changes to the Investment Bank Special Administration Regime: problems solved?

In this article, Sarah Bayliss considers how HM Treasury and the Financial Conduct Authority have responded to the recommendations in the Bloxham Report concerning making the FCA's client money rules and the Investment Bank Special Administration regime (SAR) work together better.

THE SAR

Following the 2008 financial crisis and, in particular, the difficulties encountered effecting the prompt and orderly return of client assets following the collapse of Lehman Brothers (see, in particular *Re Lehman Brothers International (Europe) (In Administration)*,[1] the UK government enacted the Banking Act 2009 (BA 2009) with the stated aim set out in s 4 of preserving financial stability and confidence in the banking system.

The Treasury is enabled by ss 232–236 to make regulations to establish a new procedure for administration of investment banks to operate either in place of, or alongside, existing UK insolvency legislation. In making regulations the Treasury is to have regard, by s 233(3), to the "desirability" of, among others, the following factors: identifying, protecting, and facilitating the return of client assets, ensuring certainty for investment banks, creditors, clients, liquidators and administrators and minimising the disruption of business and markets. The resulting "special administration" procedure unique to investment banks is set out in the Investment Bank Special Administration (England and Wales) Regulations 2011 (SI 2011/245) (the Regulations) (in force from 8 February 2011) and the Investment Bank Special Administration (England and Wales) Rules 2011 (SI 2011/1301) (the Rules) (in force 30 June 2011), referred to together as the Special Administration Regime (SAR).

As enacted, the SAR provides for a parallel administration regime for investment banks similar to the procedure available for companies in general set out in s 8 and Sch B1 of the Insolvency Act 1986. By s 232 BA 2009, the SAR applies to investment institutions incorporated in, or formed under, the law of the UK which have a Part 4 permission under the Financial Services and Markets Act 2000 to safeguard, administer or deal in investments and which hold client assets (whether or not on trust). An application for a special administration order may be made by the institution itself, its directors, creditors or the FCA (Reg 5). The regime is not mandatory, a qualifying investment company may still enter an "ordinary" administration. The main distinction between the two regimes is the emphasis placed by the SAR on:

- the timely return of investment assets to clients (Reg 10(1)(a)); and
- the importance of co-operating with the relevant authorities (Regs 10(1)(b) 13 and 16–19) in order to achieve the statutory aims set out above.

THE BLOXHAM REPORT

Section 236 BA 2009 contains a requirement that the Regulations be subject to an independent review within two years of coming into force. The review was conducted by insolvency and restructuring specialist and former Freshfields partner, Peter Bloxham. His report, 'Final review of the Investment Bank Special Insolvency Regulations 2011' (the Bloxham Report), was published in January 2014.[2]

Peter Bloxham suggested in his report that the key to a successful "bespoke insolvency scheme for investment firms" was enabling the administrator to "deal with client assets which do not belong beneficially to the failed firm" at the same time as imposing on him responsibility to prioritise the return of those assets to the client or their expeditious transfer to a successor entity. Of the recommendations set out in the Bloxham Report, the author identifies at 1.19 his top priorities in order of importance as follows:

> "… the need to (a) facilitate transfers; (b) make amendments to the Bar Date; (c) review and expand the SAR provisions associated with a client's claims against the failed firm arising out of client money and (d) consider enhancements to the FSCS regime."

This article examines Peter Bloxham's key recommendations on client money claims and the responses from the Treasury and the FCA.

CLIENT MONEY CLAIMS

Chapter 3 of the Bloxham Report makes a number of points about the operation of the SAR and its interaction with CASS, the client asset regime set out in the FCA Rules. The CASS rules provide a regime for the distribution of client money and return of client assets on the failure of a firm. Client money must be segregated from the firm's funds (CASS 7.13) and a statutory

trust is constituted when the firm receives client money with the firm as trustee (CASS 7.17). CASS 7A ensures that the protection afforded by CASS continues to apply when a firm fails by providing that the firm's failure constitutes a "primary pooling event" triggering a requirement that all the client money held by the firm be pooled and distributed to clients rateably in proportion to the value of their claims.

The report describes the court's interpretation of the CASS rules in the course of the Lehman Brothers litigation (see references above) and of the SAR in the MF Global litigation (see *MF Global UK Ltd (in special administration)*)[3] as intended to constitute "a comprehensive and autonomous regime for the distribution of the client money of a failed firm" and concludes that it has become clear that it is CASS, not the SAR, which provides for the mechanics of client asset protection.

The report identifies the distinct function of the SAR as enabling an administrator to step in as trustee and to handle client assets in accordance with CASS at the same time as dealing with the firm's general estate in insolvency. The report describes the SAR as "a mechanism to adapt general principles applicable in any administration to the requirements of a failed firm which holds or controls assets belonging to its clients".

As Peter Bloxham notes at 3.1, it is essential for the proper functioning of both CASS and the SAR that there should be no unnecessary gaps or conflicts between the two. The report then goes on to analyse the respects in which the interaction between the rules can be improved. Central to that analysis is that, when an investment firm goes into the SAR procedure, the administrator takes charge of an entity with two distinct pools of assets:

- the custody asset and client money pool together (Client Pool); and
- the assets owned by the firm beneficially (Firm Estate).

The administrator's task is to supervise two separate mechanisms in respect of distributions:

- the Client Pool to clients in accordance with CASS (and where there is a gap, general property or insolvency law); and
- the Firm Estate on a *pari passu* basis in accordance with the SAR and insolvency law generally to all unsecured creditors.

Clients of a failed institution will have parallel claims, arising out of the same relationship and transactions, both as clients (in respect of client monies, to the client money pool) and as creditors with claims in the Firm Estate.

The problem identified by Peter Bloxham is that these parallel claims are likely to be accorded different values for CASS and SAR purposes because the two systems operate different rules as to valuation. The client money entitlement (determined by CASS) will be based on a notional calculation carried out as at the date of the primary pooling event. By contrast, creditor claims will be calculated accurately and with the benefit of hindsight in accordance with general insolvency principles once the administrator has ascertained the funds which are in fact in the Firm Estate (referred to as the "Hindsight Principle").

The Bloxham Report stresses the desirability of consistency between the two measures and expresses the view at 4.9 that the claim in the Firm Estate is likely to be a more accurate reflection of the client's actual loss and that the client money pool "ought as a matter of principle, to protect no more and no less than a client's contractual entitlement as eventually determined".

The fact that the calculation under CASS 7A of the client's entitlement to funds from the client money pool takes place early using the notional closing or settlement price prevailing at the primary pooling date, rather than the actual close out value, can lead to a shortfall in the client money available for distribution. Peter Bloxham identifies a significant lacuna in the rules in that neither the SAR nor CASS addresses what happens when such a shortfall arises.

THE RECOMMENDATIONS

Peter Bloxham's key recommendations on making CASS and SAR work together better are as follows:

> "SAR and CASS need to be consistent: clarity on clients' rights to income, interest and/or distributions in respect of Client Assets and interest on Client Monies, in respect of period of administration, and which rules to apply". Recommendation 8.

> "Amend drafting of SAR objectives to provide that Administrator's role … is to apply applicable distribution regime laid down by CASS. This is to make clear that the client's entitlement as a client is to be sought in CASS." Recommendation 9.

> "Ensure relationship between client's rights under CASS in respect of Client Assets and his rights to make claims as a creditor are clearly set out and understood and do not operate unfairly to other creditors." Recommendation 10.

> "SAR should set out the basis on which clients making partial recoveries of Client Monies under CMP [client money pool] entitlement are entitled to make claims against the failed firm's estate." Recommendation 11.

> "FCA to consider whether Hindsight Principle could be introduced for CASS Client Money Pool Entitlement purposes." Recommendation 14.

THE RESPONSE

The Treasury responded to the recommendations in the Bloxham Report in March 2016 in its consultation paper, 'Reforms to the investment bank special administration regime review' (Treasury Consultation Paper)[4] and published draft amendments to the SAR in the Investment Bank (Amendment of Definition) and

Feature

Biog box
Sarah Bayliss is a barrister practising from XXIV Old Buildings, Lincoln's Inn.
Email: sarah.bayliss@xxiv.co.uk

Special Administration (Amendment) Regulations 2017 (Draft Regulations).[5] In January 2017 the FCA published a further consultation paper, 'CP17/2: CASS 7A and the special administration review'[6] (FCA Consultation Paper), along with draft amendments to the client asset rules set out in the CASS module of the FCA Handbook.

In chapter 4 of the Treasury Consultation Paper, Recommendation 8 and the need for consistency between CASS and SAR are accepted. The lacuna in the rules concerning what is to happen on the occurrence of a shortfall in the client money pool as a result of the notional valuation of entitlement at the time of a primary pooling event is addressed in Draft Regulation 9 (to become Reg 10F) which provides that the administrator must carry out a final client money reconciliation and, if there is a shortfall between the total amount of money held in client accounts and the amount that should have been segregated according to CASS, the firm is to make up the difference from its own funds. Similarly, if there is an excess of client money, the excess is to be paid over to the firm's own accounts for distribution in the firm's insolvency.

As to Recommendation 8 (rights to interest) and Recommendation 10 (in relation to fair treatment of clients and other creditors), paras 4.6–4.7 of the Treasury Consultation Paper draw attention to the discrepancy as to entitlement to interest between claims to money in the Client Pool and the client's parallel claim as creditor in the Firm Estate. Clients are not entitled to receive interest on their client money during administration but where there is a surplus after payment to creditors of debts in the Firm Estate, those creditors are entitled to interest.

The Treasury Consultation Paper expressed concern that this had led some clients to delay submission of their claims with a view to claiming from whichever of the Client Pool or Firm Estate was most likely to offer the better return and concluded "the government's view is that there is a compelling public interest in preventing arbitrage by clients that results in detriment to the generality of clients and creditors".

The Draft Regulations address this problem by taking away any advantage a client might have as a result of claiming in the Firm Estate as opposed to the Client Pool. Draft Regulation 9 (to become Regulation 10G) provides that where a client chooses to make a claim as creditor in the Firm Estate in preference to a claim for money from the Client Pool, he will not be entitled to interest on any sum he would have received had he claimed for a distribution from the Client Pool. A client who claims in the Client Pool first and then seeks any shortfall in the Firm Estate will be entitled to interest on any balance received by way of distribution in the event of a surplus.

Recommendation 9 (to state expressly by way of clarification in the SAR that a client's entitlement to the client money pool is to be determined by the application of CASS) has not been adopted by the Treasury on the basis that the law in this respect is already clearly set out in the judgments in the Lehman Brothers and MF Global litigation.

The Treasury also has reservations in relation to Recommendations 10 and 11 (clarification of client's rights to make claims). In chapter 6 of the Treasury's Consultation Paper ("Lessons learned"), it is noted that in *MF Global UK Ltd (in special administration)*[7] findings were made about three kinds of claims that a client who has client money held by the firm might be able to bring in insolvency proceedings, namely: a "CASS claim" based on the statutory trust, a "Shortfall claim" for breach of trust against the Firm Estate where there are insufficient funds in the Client Pool fully to meet the CASS claim and a "Contractual claim" as an unsecured creditor of the Firm Estate. The Treasury concludes that:

> "… the government believes it is for the courts to decide what claims a client is able to make under different circumstances. Codifying the types of claims clients are able to make could have unintended consequences because it would trespass on matters which are properly governed by general principles of law and the application of insolvency legislation."

At 4.17–4.18 the Treasury agrees with Recommendation 14 that "adopting the hindsight principle could help address the problems that arise as a result of the basis of calculation of shortfall claims and the need for clients to make multiple claims in an insolvency" but considers that the most appropriate legal vehicle for such a change is CASS. The FCA proposes to extend the operation of the hindsight principle in CASS to the limited extent of using it to value cleared open margined transactions following a primary pooling event but does not propose to extend the application of the principle further on the basis that it would be too complex or impractical to apply to other types of trades.

As at the date of writing, it is anticipated that the Draft Regulations will come into force in the near future. While issues will inevitably arise in negotiating the complexity of the interaction between two distinct regulatory regimes, these changes are to be welcomed and it is to be hoped that the new Regulations, the proposed amendments to CASS and the judgments in the Lehman Brothers and MF Global litigation, in combination, will assist administrators and their advisers in achieving a fair and timely outcome for clients and creditors of financial institutions in special administration. ■

1 [2009] EWCA Civ 1161 and [2012] UKSC 6.
2 Available at www.gov.uk/government/publications/review-of-the-special-administration-regime-sar-for-investment-banks
3 [2014] 2222 (Ch); [2013] EWHC 1655 (Ch); [2013] EWHC 92 (Ch) and [2013] EWHC 2556.
4 Available at www.gov.uk/government/publications
5 Available at www.fca.org.uk/publications/consultation-papers/cp17-2-cass-7a-and-special-administration-regime-review
6 Available at www.fca.org.uk/publications
7 [2013] EWHC 2556.

Further Reading:

- The Special Administration Regime for investment banks: is it fit for purpose? [2014] 5 JIBFL 283.
- CASS compliance: legal issues, unfair contract terms and risks for senior managers [2015] 7 JIBFL 410.
- LexisPSL: Banking & Finance: From Lehman to Bloxham: what next for the Special Administration Regime?