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From Lehman to Bloxham: what next for the Special Administration Regime?

KEY POINTS

- In the aftermath of the Bloxham report, HM Treasury is consulting on proposed changes to the Special Administration Regime while the Financial Conduct Authority is carrying out a simultaneous review of the relevant CASS rules.
- One of the key Bloxham proposals that the government plans to adopt is an extension of the bar date to include client money claims.
- There are limitations to the proposed reforms. For example, in relation to client money the reforms arguably do not extend far enough to address and resolve all the client money issues which have been exposed since the SAR's creation. Moreover, there is a strong case for carrying out a more radical review of the law under which client entitlements can arise and whether it is appropriate to continue to rely on property, trust and insolvency law concepts in the context of fast moving and intangible rights of modern and sophisticated investment markets.

BACKGROUND AND CONTEXT

The 2008 insolvency of Lehman Brothers and the collapse of other prominent banks in the largest financial crisis in living memory, showed starkly how close we had come to an unstructured collapse of the entire banking system which could have in turn brought about calamitous economic and social consequences. This awareness of how near we all came to disaster led to a global response and an overhaul of the legal tools available to best rescue or resolve banks.

When the main English entity in the Lehman group, Lehman Brothers International (Europe) ('LBIE') went into administration, the administrators had to operate under exactly the same set of rules as in any ordinary administration. Although the administrators ultimately delivered a very successful outcome (returning property to former customers and generating a substantial surplus available for distribution), the administrators had to overcome legal uncertainties arising from the fact that, as an investment firm, LBIE held assets and monies (with an aggregate value running into many billions) for customers which were not property of the failed firm. The administrators developed their own solutions for managing and distributing the trust estate of client assets and client monies alongside the general estate for the firms' creditors. The author helped the administrators develop these solutions. But the question remained as part of the reforms to improve the stability of the financial system, should there be a specific legal regime introduced for future failed investment firms to ensure the effective and swift distribution of customer assets? This point was forcibly made by some when comparing the operation of the UK rules to the US regime for failed investment firms under the Securities Investors Protection Act of 1970 (SIPA 1970).

The Banking Act 2009 (BA 2009) acknowledged this issue and afforded HM Treasury power to introduce regulations which would provide for a bespoke insolvency regime for investment firms. Pursuant to that power, in 2011 the Investment Bank Special Administration Regulations 2011 (SI 2011/245) introduced the Investment Bank Special Administration Regime (SAR). The SAR introduced a mechanism to modify insolvency principles in the administration of a failed firm holding or controlling assets belonging to its clients to ensure that the return of customer assets which are not part of the assets of the firm are dealt with as a priority.

Key points are that the SAR:

- gives the administrator jurisdiction over the distribution or transfer of client assets;
- requires the administrator to prioritise dealing with those assets;
- imposes on the administrator and certain third parties duties designed to facilitate the identification, collection and transfer or return of client assets; and
- allows for the use of a bar date mechanism in connection with distributions of non-cash client assets.

However, there is an important gap. The SAR excludes the operation or substance of the rules protecting client monies. Those rules are set out in the Client Asset Sourcebook (CASS) and were themselves subject to their own review by the Financial Conduct Authority (FCA). The operation of CASS in the LBIE case and subsequently in the litigation relating to MF Global has been the subject of much commentary and some criticism. Although LBIE customers did not ultimately lose out, the operation of the CASS rules gave rise to significant difficulties in their interpretation and application, not all of which were resolved notwithstanding extensive litigation. On account of these difficulties HM Treasury took the view that it would be too complex to bring reform of client money into the SAR. Client monies remain a separate topic.

The Banking Act required the SAR to be reviewed within two years of coming into force. Peter Bloxham, a former partner of the author, carried out that review. His report was published in January 2014. The Bloxham review recommended that the SAR be retained and proposed 72 reforms to strengthen the regime. In March 2016 HM Treasury published its response to the Bloxham review. At the same time the FCA published its own discussion paper (DP16/2: *CASS 7A & the Special Administration Regime Review*). The intention is that reforms to the

SAR and reforms to the FCA rules covering the return of client money (CASS 7), custody assets (CASS 6) and the CASS Resolution Pack (CASS 10) should go forward hand in hand.

The SAR has seen rather more use than other bank resolution tools. Since its inception, the SAR has been employed in at least six cases. The biggest of these was MF Global where the return of client monies was compared unfavourably with the operation of the SIPA regime in the related insolvency in the United States.

THE PROPOSED REFORMS

Transfer of assets

Objective 1 of the SAR is for the administrator to return client assets as soon as is reasonably practicable. But the SAR does not provide any mechanism for doing so. The obvious way to return assets would be to allow for the transfer of client assets and contracts to a new firm which is not insolvent. That would provide continuity of services and the assets would no longer be locked up in a protracted insolvency process. The transfer of customers on a 'going concern' basis might lead to a better return to creditors and it would enable the administrators to better concentrate their prioritised efforts on the remaining clients whose assets are not transferred.

However, under current law a novation would require individual consent contract by contract, customer by customer which may often be completely unrealistic and there a number of other practical difficulties to be overcome in moving customers out of the failed firm. The ability to transfer client positions en-bloc without the need for customer consent is a key element of SIPA 1970 and its absence has undoubtedly impaired the effectiveness of the SAR.

Bloxham recognised this gap in his review and recommended changes to enable transfers. HM Treasury is proposing to make it much easier to transfer assets by introducing the ability to novate client contracts by operation of law so that individual client consent is no longer required and to bring in new rules to override any restrictions which might otherwise obstruct such a transfer (such as a prohibition on assignment). There will be safeguards for set-off and netting arrangements. There will also be a number of other consequential protections – clients will be able to promptly request a return of their assets from the transferee firm, custodians will be restricted from terminating custody arrangements with the failed firm if that would prejudice a transfer and administrators will be permitted to disclose customer confidential information if doing so is relevant to the transfer of the assets.

The effect should be to facilitate a much speedier return of customer property.

Bar dates

One of the issues in the LBIE administration was that under the general law of trusts and property any proprietary claims for trust property would survive a distribution by the administrators and the recipient could be forced to turn over the property he received. To help bring greater certainty and finality, the SAR gave the administrators the power to set a bar date (for asset claims) and claimants could not challenge a distribution made in good faith after a bar date. This operates to extinguish the property rights of persons who fail to claim by the bar date. However, the current bar date is only a 'soft bar date' because the claimant can still assert proprietary claims into later distributions. This has prevented administrators from closing the client estate in a case where the residual assets came in.

HM Treasury has accepted Bloxham's recommendations that the bar dates should extend to include client money, that there should be greater flexibility about the manner of distributions under the bar date mechanism and that the SAR should allow for a 'hard bar date' which would allow administrators to safely transfer unclaimed residual assets and client money to the failed firms' general estate. All of these reforms should speed up and simplify dealing with the administration of the failed firm.

Costs

Re Berkeley Applegate (Investment Consultants) Ltd (in liquidation) [1988] 3 All ER 71 established that the costs of the administration of a trust estate can be borne out of the trust property. However, the actual process of allocating costs between the general estate and the trust estate is not straightforward. In particular the customers may end up having to bear the additional costs caused by the firm's failure to comply with its regulatory obligations. HM Treasury has accepted Bloxham's recommendation that these costs could be allocated to the general estate.

Client monies

Largely, HM Treasury has ducked the opportunity to use the review to make the treatment of client money claims aligned more closely with the treatment of claims relating to custody assets.

There are some helpful changes proposed. In particular, HM Treasury proposes removing the arbitrage between client money trust claims (on which no interest claim arises) and contractual claims for the same money which as an unsecured claim would benefit from an interest claim. They further propose allowing the administrators to 'top-up' client money accounts out of the failed firm's general estate to the extent that the top up payment reflects the final reconciliation of the accounts that was blocked by the commencement of the administration.

However, although Bloxham urged them to adopt a more wide ranging approach to making client asset and client money rules consistent, HM Treasury has declined to do so. This failure will leave open the many difficulties regarding client monies (of which the identification of client money and tracing are but two) unless and until the CASS rules are adequately revised to solve them. The work on revising CASS to deal with this is still incomplete and given the framework (including EU directives) under which the CASS rules operate, reform is complex. Despite this not being the place to examine the proposed revisions to CASS which are the subject of further consultation, it would be reasonable to say that the challenges and

Feature

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difficulties of the issues faced are such that HM Treasury has decided that this zone is a minefield which they do not wish to step into.

WHAT ISSUES REMAIN?

The SAR has proved useful and proved itself in a number of cases. These proposed changes will make it work better still. But have we made material progress?

If we consider the outcome for customers in the LBIE case, the UK regime outside of the SAR was both flexible and adaptable enough to lead to successful return of property which in many respects compares favourably with SIPA 1970 and will certainly do so even more once the new transfer arrangements for customers are available. What SIPA 1970 and the client money rules both have in common is a pooling approach where following failure of the firm, the assets (or, under CASS, the client money) is held in a single pool for all of the eligible claims. The issues with pool allocation have been a material road bump in LBIE and MF Global and presented significant difficulties for assets held in the US Lehman process on behalf of customers outside of the United States.

One of the virtues of the SAR is that it recognised the value and strength of the existing UK regime and did not foist a pooling process onto customer assets. In fact, the SAR generally enhances the existing flexibility and adaptability of the UK insolvency regime at least in so far as it relates to client assets. However, so far as client money is concerned, the proposed new SAR reforms are somewhat helpful but do not extend far enough to address and resolve all the client money issues which have been exposed.

Further, Bloxham identified the need to consider a more radical review of the law under which client entitlements can arise and whether it is appropriate to continue to rely on property, trust and insolvency law concepts in the context of fast moving and intangible rights of modern and sophisticated investment markets. For its own reasons, HM Treasury has decided not to explore these deeper waters. Changing insolvency processes is of some limited value but in the final analysis the rules will always simply be a mechanism for applying underlying legal principles. It appears that a more profound and more wide ranging review of the principles of which property rights should be protected and how best such rights should be protected will have to wait, perhaps until the next financial crisis. ■

Further reading

- LexisPSL Restructuring and Insolvency: Practice note: The Investment Bank Special Administration Regulations 2011
- The Special Administration Regime for investment banks: is it fit for purpose?: Journal of International Banking and Financial Law (2014) 5 JIBFL 283
- LexisPSL Restructuring and Insolvency: Practice note: Special resolution regime options

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