

Alert

UK Special Administration Regime

3 November 2011

The UK Financial Services Authority ("FSA") confirmed on 31 Oct. 2011 that MF Global UK Limited ("MF Global UK") will be subject to the new Special Administration Regime ("SAR").¹ This is the first time that the new regime, set out in The Investment Bank Special Administration Regulations 2011 ("SAR Regulations")² has been invoked.

Background

The SAR Regulations were made under the powers set out in Sections 233 and 234 of the Banking Act 2009. They came into effect on 8 Feb. 2011 and are supplemented by The Investment Bank Special Administration (England and Wales) Rules 2011³ ("SAR Rules") which came into force on 30 June 2011.

The purpose of the new SAR is to address perceived deficiencies in the UK insolvency regime in the case of the collapse of an investment bank and highlighted by the collapse of Lehman Brothers in 2008 such as:⁴

- Ascertaining which assets are client assets and which firm assets;
- Interpreting the effect of, and the interrelationship between, various contracts and master agreements such as prime brokerage agreements, futures agreements, stock lending agreements and ISDA master agreements;
- Establishing the extent of any right of use; and
- Determining and allocating any shortfalls in client omnibus accounts.

Applicability to Investment Banks

The SAR Regulations apply to investment banks as defined under the Banking Act 2009. These are firms which:

1. Have permission under Part 4 of the Financial Services and Markets Act 2000 to carry on the regulated activities of:
 - (a) Safeguarding and administering investments,
 - (b) Dealing in investments as principal, or

¹ <http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/089.shtml>

² <http://www.legislation.gov.uk/uksi/2011/245/contents/made>

³ <http://www.legislation.gov.uk/uksi/2011/1301/contents/made>

⁴ http://www.hm-treasury.gov.uk/d/consult_sar_160910.pdf

- (c) Dealing in investments as agent.
2. Hold client assets; and
3. Are incorporated in or formed in the United Kingdom.

The SAR Regulations apply to UK-firms (and where the UK-firm is part of a wider group of companies, it will not apply to any non-UK affiliate). Accordingly, in the case of MF Global, the SAR Regulations are only being applied to MF Global UK, a UK-firm, but will not apply to MF Global in the United States.

Additionally, the SAR Regulations would not apply to a branch of a non-UK firm carrying on business in the United Kingdom.

Administrator's Objectives

The SAR Regulations set out three special objectives for an administrator under the new regime:

1. Ensuring the return of client money or assets as soon as is reasonably practicable;
2. Ensuring timely engagement with market infrastructure bodies and authorities such as The Bank of England, HM Treasury and the FSA; and
3. Either rescue the investment bank as a going concern, or wind it up in the best interest of the creditors.

This essentially might be said to codify existing best practice. Whilst the administrator has the power to determine the priority of these objectives, the FSA can, in certain circumstances, direct the administrator to prioritise one or more of the objectives, if it is necessary to do so in order to maintain public confidence in the stability of the financial markets in the United Kingdom.

The SAR Regulations set out the means by which an administrator under the SAR may seek to achieve the above objectives. For example, the special administrator has the power to set a bar date for claims to client assets to help expedite the return of client assets. The SAR Regulations provide that where there is a shortfall in client assets which are held in an omnibus account, that shortfall will be shared pro rata between the clients claiming those assets. This avoids having to address complex issues under trust law as to the allocation of losses. The SAR Regulations also contain provisions relating to the continuity of supplies for a limited period so as to assure the administrator of continued access to key services such as data feeds, network services and the like, the absence of which might disrupt the identification and return of client assets.

The SAR Rules supplement the SAR Regulations and set out some of the mechanics behind the SAR Regulations, such as who is entitled to attend creditors meetings (all clients of the investment bank, as a separate class of creditors, as well as all creditors in the ordinary course) and how they operate, and provide, among other things, that the costs of returning client assets will be paid for out of the client assets.

Future Developments

The SAR is essentially an interim regime. It was introduced to ensure that, following the collapse of Lehman Brothers, there was still confidence in the UK investment banking sector. At the same time, it was recognised that the SAR may not be optimal or may have unintended consequences. Accordingly, under Section 236 of the Banking Act 2009, the SAR Regulations are to be reviewed within two years of their coming into effect to determine whether they are fit for purpose and whether they should remain in effect. In its press release on 31 Oct. 2011 in relation to MF Global UK, the FSA describes the objectives of the administrator under the SAR as including the "swift return of client assets and the timely engagement with market infrastructure".⁵ Whether or not the administrator of MF Global UK manages to achieve this objective will clearly inform the future review of the SAR Regulations.

Separately, the FSA is currently conducting a market consultation in relation to a proposed requirement for financial services firms to maintain Recovery and Resolution Plans ("RRPs") — "living wills".⁶ The purpose of

⁵ <http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/089.shtml>

⁶ http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf

such a “living will” would be to set out recovery options which may be mobilised quickly and effectively in the event of a firm running into financial difficulties. The FSA expects to publish final rules following the consultation in the first quarter of 2012 with transitional provisions enabling firms to prepare their initial RRP by June 2012.

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