EXPLANATORY MEMORANDUM TO THE INVESTMENT BANK SPECIAL ADMINISTRATION (SCOTLAND) RULES 2011

2011 No. 2262 (S.3)

1. This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty. This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 The instrument introduces the insolvency rules for the investment bank special administration procedures established in the Investment Bank Special Administration Regulations 2011 (S.I. 2011/245) ("the Regulations").

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative context

4.1 The Investment Bank Special Administration (Scotland) Rules 2011 ("the Rules") are being introduced under section 411(1A) (b), (2), (2C) and (3) of the Insolvency Act 1986 (c. 45) (as modified by regulation 15(6) of the Regulations). It follows the introduction of the Regulations which were made on 7 February 2011 under section 233, 234 and 259(1) of the Banking Act 2009 (c. 1).

5. Territorial extent and application

5.1 This instrument applies to Scotland.

6. European Convention on Human Rights

6.1 As the instrument is subject to the negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

What is being done and why

7.1 Following the insolvency of Lehman Brothers in the UK, it became apparent that there were unanticipated legal complexities in winding up an investment bank.

7.2 After considering the responses of three consultation papers and the advice of an Investment Banking Liaison Panel, the Government legislated for a new special administration regime for investment banks. This regime came into force on 8 February 2011 through the Regulations.

7.3 These Rules set out the procedure for the Investment Bank Special Administration process under the Regulations. Insolvency rules are necessary to set out the detailed processes of an insolvency procedure. By introducing specific rules to accompany the Regulations an administrator will have clarity over the processes which need to be followed in winding up an investment bank under the Regulations.

7.4 The main features of Investment Bank Special Administration are that:

- the investment bank enters the procedure by court order;
- the order appoints an administrator;
- the administrator is to pursue the special administration objectives in accordance with the statement of proposals approved by the meeting of creditors and clients or, in certain circumstances, the Financial Services Authority; and
- in other respects the procedure is similar to administration under Schedule B1 to the Insolvency Act 1986.

7.5 Where the investment bank is also a deposit-taking bank, the Rules also apply in relation to the Special Administration (Bank Insolvency) and Special Administration (Bank Administration) processes as established under Schedules 1 and 2 to the Regulations.

7.6 These Rules are based on the rules applicable to administration set out in the Insolvency (Scotland) Rules 1986 (S.I. 1986/1915), the Bank Insolvency (Scotland) Rules 2009 (S.I. 2009/351) and the Bank Administration (Scotland) Rules 2009 (S.I. 2009/350), and many of these existing rules have been applied with little or no modification.

7.7 New rules, and modifications to existing rules, have been introduced in order to facilitate the achievement of the unique objectives of the special administration procedures set out in the Regulations. The most significant new rules are set out below.

<u>Client voting procedure and establishment of creditors' committee (Part 3 of the Rules)</u>

7.8 The statement of proposals drawn up by the administrator sets out the priority to be given to the three objectives set out in the Regulations. The statement of proposals must be approved by the meeting of creditors and clients. The Rules set out how such approval is to be achieved.

7.9 In normal administration proceedings, creditors must be given notice of the meeting of creditors and then, in order to be able to vote at the meeting, must give the administrator details of their claim and have that claim accepted wholly or in part by the administrator.

7.10 The creditor's vote is calculated according to the amount of their claim as of the date the investment bank went into special administration, making adjustments for any amounts already repaid.

7.11 The Rules set out that under the Regulations clients are to be notified of meetings in the same way as creditors and that:

- a client must submit his claim for client assets to the administrator prior to the meeting (note that this submission would be in a much shorter form than the submission made in response to a bar date - see paragraph 7.14 below);
- the administrator has powers to reject/ admit /object to a claim;
- if the claim is for client assets, the value of a client's vote will be based on the value of those assets. Where the assets are not money, the chair will put on the assets an estimated value based on the value of those assets as on the closing of the markets on the business day prior to the investment bank entering special administration;
- the creditors and the clients will vote separately to approve the statement of proposals (this is because the total amount of debt owed by the investment bank and the total amount of client assets due to be returned are different types of liability and should not be combined). The statement must be approved by both groups – on a simple majority basis in each case; and
- a client who is also a creditor has the right to vote in both groups provided that they have submitted their respective claims correctly in each case.

7.12 The meeting of creditors and clients will also be able to appoint a creditors' committee. In order to ensure that this committee is a reasonable reflection of the interests of creditors and clients, the administrator will be required to determine the appropriate make-up of the committee and to direct that nominations are made and then voted on by the meeting in a manner that achieves that make-up.

Costs of the realisation of client assets (Part 4 of the Rules)

7.13 In the application of paragraph 99 of Schedule B1 of the Insolvency Act 1986, the costs of the administrator in pursuing Special Administration Objective 1 (ensuring the return of client assets as soon as is reasonably practicable) shall be borne by the clients. The Rules provide that the administrator shall propose in the distribution plan for client assets how the administrator is to retain certain client assets to pay the expenses of the administration in pursing Special Administration Objective 1.

Bar dates (Part 5 of the Rules)

7.14 If the administrator decides to set a bar date for the submission of claims to client assets, the Rules set out how claims are to be made and the process leading up to the distribution following the bar date. The decision as to what can be distributed and at what stage will be left to the administrator's discretion (which is then subject to approval by the creditors' committee and by the court), but the Rules set out the process by which this is to be achieved. The Rules include details as to:

- what the claim must contain (this applies both to clients claiming a beneficial interest or other interest in the assets held, and also to third parties claiming security interests over those assets);
- the process by which the administrator "flushes out" late claimants (i.e. those who have not submitted their claim before the bar date). If the administrator believes from records of the investment bank that a client may have a claim for client assets, the administrator will contact the client and put him on notice that he believes that the client has assets with the firm and that he proposes to calculate the client's claim according to the information he has unless he hears otherwise from the client; and
- the approval of a distribution plan by the creditors' committee as to the distribution of both encumbered and unencumbered assets. This enables the administrator to set out: his plan for the distribution; the amount of distributions to be made; when those distributions are to be made; the size of any buffer of assets kept back from the initial distributions; how contingent claims or disputed claims are to be dealt with; and how the expenses of the special administration in realising and returning the client assets are to be funded from the client assets (see paragraph 7.13). Court approval will then need to be sought for the distribution plan.

7.15 Note that the above applies only where the administrator sets a bar date. There is nothing to stop the administrator releasing unencumbered client assets, before setting a bar date for the more complicated claims.

7.16 As regards the treatment of a claimant who makes a late claim, the Regulations provide that if a distribution has taken place, then this claimant cannot pursue any assets that have already been distributed.

7.17 The Rules set out that if there are sufficient assets remaining to cover what the claimant should have received in the distribution, then these will be paid out before the administrator makes another distribution, and the late claimant will participate fully in subsequent distributions. However, if there are insufficient assets, then the claimant becomes an unsecured claimant against the estate for the value of the shortfall of his claim.

Consolidation

7.18 The Rules do not amend other instruments so the issue of consolidation is not applicable.

8. Consultation outcome

8.1 Responses to the most recent consultation paper on the Regulations, *Special administration regime for investment firms* (www.hm-treasury.gov.uk/d/consult_sar_160910.pdf), which consulted on significant proposals for the new rules (see paragraphs 7.8-7.17 above) were broadly supportive. Responses

to the consultation paper are available on HM Treasury's website (www.hm-treasury.gov.uk/consult_investment_banks2.htm).

8.2 The Treasury has also sought the views of its Investment Banking Liaison Panel of industry practitioners, and has worked closely with officials from the Insolvency Service, Bank of England, Financial Services Authority, Companies House, Office of the Advocate General, and the Office of the Lord President of the Court of Session to develop the Regulations and the accompanying Rules.

9. Guidance

9.1 No guidance is being issued on the instrument since it is largely based on existing insolvency rules and practice which will be familiar to insolvency practitioners and their advisers.

10. Impact

10.1 There is no impact on businesses, charities, public sector or voluntary bodies. An Impact Assessment is attached to this memorandum and will be published on www.legislation.gov.uk

11. Regulating small business

11.1 The legislation applies to small business; however, there are no costs to business resulting from the legislation. Therefore, no measures need to be taken to minimise the impact of the requirements on firms employing up to 20 people.

12. Monitoring & review

12.1 Section 236 of the Banking Act provides for HM Treasury to review the Regulations within two years of them coming into force. The review must consider how far the Regulations are achieving the objectives specified in section 233(3) and whether the Regulations should continue to have effect. The Rules will be considered as part of this review.

12.2 HM Treasury will ensure that arrangements for review are consistent with better regulation policy going forward.

13. Contact

Heather Kempton at HM Treasury, Tel: 020 7270 5510 or email: heather.kempton@hmtreasury.gsi.gov.uk, can answer any queries regarding the instrument.