Association of Business Recovery Professionals

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HM Treasury
Managing the failure of systemic digital settlement asset (including stablecoin) firms

Email only – fmisar.stablecoin@hmtreasury.gov.uk

Wednesday 26 July 2022

Dear Sir / Madam,

HM TREASURY
CONSULTATION: MANAGING THE FAILURE OF SYSTEMIC DIGITAL SETTLEMENT ASSET (INCLUDING STABLECOIN) FIRMS
RESPONSE FROM INSOLVENCY AND RESTRUCTURING TRADE BODY R3

1. INTRODUCTION

1.1 R3 is the trade association for the UK's insolvency, restructuring, advisory, and turnaround professionals. We represent licensed insolvency practitioners, lawyers, turnaround and restructuring experts, students, and others in the profession. Our members work across the spectrum of the profession, from global legal and accountancy firms through to smaller, local practices.

1.2 The insolvency, restructuring and turnaround profession is a vital part of the UK economy. The profession rescues businesses and jobs, creates the confidence to trade and lend by returning money fairly to creditors after insolvencies, investigates and disrupts fraud, and helps indebted individuals get back on their feet. Our members have direct experience of restructuring and insolvencies and their impact on the UK economy and various stakeholders.

1.3 This response has been prepared by R3 in collaboration with members of its General Technical Committee. The Committee deals with issues of general importance and significance to the profession in the United Kingdom, keeping under review all UK and EU legislation, prospective and other matters relating to insolvency law. The Committee is multi-disciplinary and is made up of representatives from across the insolvency and restructuring profession, including practising insolvency practitioners, lawyers (including those specialising in advising regulated entities), in addition to academics, and others.

2. GENERAL OBSERVATIONS

2.1 Given the recent reported turmoil in the stablecoin market and the increased need for regulatory scrutiny of cryptoassets, R3 welcomes this consultation, which aims to ensure that the appropriate tools are available to mitigate potential financial stability issues if a systemic Digital Settlement Asset ('DSA') firm fails.

2.2 Special Administration Regimes ('SARs') can be a vital tool for financial services firms as they allow for a bespoke insolvency provision in cases when the ordinary administration process is not in the best interests of the public. For the most part, SARs do seek to strike a fair balance between clients and other creditors, and should normally speed up the process of return of client money and instruments in the event of a firm's failure.

2.3 As this consultation refers to the need for a bespoke legal framework for systemic DSA firms, HM Treasury may wish to bear in mind that there is a coherency problem when a SAR is created for every instance where the Government might need to step in to promote the soundness of the financial markets. R3 awaits a further consultation to provide more detail on this point, but welcomes the expansion and use of an existing SAR (as proposed) rather than the creation of an entirely new one.

3. CONSULTATION QUESTIONS

Q1: Do you have any comments on the intention to appoint the FMI SAR as the primary regime for systemic DSA firms (as defined at para 1.8) which aren't banks?

3.1 Generally, R3 supports the Government's view that it is important to ensure existing legal frameworks can be effectively applied to manage the risks posed by the possible failure of DSA firms, for the purposes of financial stability.

3.2 Given the need for a bespoke legal framework for DSAs, we would welcome greater clarity as to whether the application of the Financial Market Infrastructure Special Administration Regime ('FMI SAR') as the primary regime for systemic DSA firms is intended to be temporary or permanent.

3.3 Due to the potential for a DSA firm to have no liquid assets at the point of insolvency / triggering of the FMI SAR, the appointed administrators may need access to no-recourse or limited-recourse funding from the Treasury to conduct the insolvency. Absent that, the firm may be forced into Compulsory Liquidation, with the potential disorderly winding up that could ensue.

3.4 Please see additional comments in response to question 2 below regarding the distribution of assets. If the FMI SAR is to be used with the additional objective, it seems that there may need to be material additions to the FMI SAR from other regimes to cover implementation of the objective, which could potentially suggest that the FMI SAR is not the right starting point.

Q2: Do you have any comments on the intention to establish an additional objective for the FMI SAR focused on the return or transfer of customer funds, similar to that found in the PESAR, to apply solely to systemic DSA firms?

3.5 The additional objective to focus on the return or transfer of customer funds appears appropriate to the extent that systemic DSA firms hold customer funds.

3.6 This does, however, raise a wider question regarding the distribution of assets. Para 2.9 of the consultation refers to *"the return or transfer of funds and custody assets"*.

3.7 The FMI SAR currently has no provision for the distribution of trust assets to beneficiaries, nor any provision for the payment of unsecured creditors. Further, while it incorporates some parts of Schedule B1 to the Insolvency Act, it excludes paragraph 82 (moving from administration to Creditors' Voluntary Liquidation). As a result, if an additional objective of returning customer funds is going to be added to the FMI SAR, it will also be necessary to add a structure for implementing the objective. With respect to any trust assets, the Investment Bank Special Administration Rules or the Payment and E-Money Special Administration Regime ('PESAR') may be a helpful starting point. Points to consider include:

a. Will there be guidance/a clear definition as to what constitutes *"customer funds"* for the purpose of the additional objective? If the return of *"customer funds"* is to be prioritised as an objective, counterparties and the administrators will benefit from certainty as to which funds the objective applies to. Similarly, will there be guidance for administrators as to how to categorise and pool classes of customer funds, given Client Assets Sourcebook (CASS)/similar rules do not apply? It is worth noting that the administrators have discretion under the PESAR as to which order to deal with and return *"relevant funds."* Will administrators have similar discretion under an amended FMI SAR regime?

b. Will additional mechanics be incorporated into the FMI SAR relating to the *"customer funds"* objective as set out in the PESAR – such as reconciliation of balances, transfer of customer funds, determination of claim entitlements, how to deal with shortfalls (including ability to claim as unsecured creditor for any shortfall), bar date, interest, or transfer of unclaimed funds to the institution?

c. Will costs of dealing/returning *"customer funds"* be borne by individual customers? How should such costs be dealt with in relation to illiquid assets – should customers be required to pay their share of costs before receiving their asset, or should such assets be liquidated to pay costs and return balance to customers?

d. Will any interest be payable in cash even if the asset is non-cash?

f. Will firms be designated by the Bank of England/Treasury as systemic and will guidance be issued as to the criteria which the Bank of England/Treasury will apply when making such designation, so that parties have an indication of the sort of firms that might be designated as such in the future? See, for example, part 5 of the Banking Act 2009 in relation to the designation of inter-bank payment systems (which only applies to banks and buildings societies).

3.8 We note that, under the PESAR, it is for the special administrators to determine the priority of the objectives (subject to directions being received from the Financial Conduct Authority or 'FCA'). We would suggest the FMI SAR is done on a similar basis.

Q3: Do you have any comments on the intention to provide the Bank of England with the power to direct administrators, and to introduce further regulations in support of the FMI SAR to ensure the additional objective can be effectively managed, or what further regulation may be required?

3.9 The inclusion of a Bank of England right to direct administrators as to which of the two objectives should take priority can be beneficial on one level. However, administrators (and legal advisors) should have some kind of certainty as to what they're dealing with, and that includes knowing how an insolvency process should work in advance of an appointment.

3.10 Therefore, any outcome or objective should be chosen in conjunction with the administrator, who has experience in dealing with insolvency matters.

3.11 Under the FMI SAR, the Bank of England has the power to direct the FMI administrator to take, or refrain from taking, specified actions, in the public interest. For instance, the Bank of England may wish to direct the FMI administrator to prioritise critical services to maintain the stability and confidence in the financial system. Given the instability of DSAs and the potential for limited assets being available to fund the FMI SAR, will funding be available from the Bank of England (or FCA) to pay for the costs and expenses of an administrator?

3.12 The FMI SAR currently gives both the administrator and the company immunity from liability in damages, in respect of action or inaction in accordance with a direction from the Bank of England. The effect of giving the company (as opposed to the administrator) immunity may be unclear in some situations. If the effect of the Bank of England's direction is that a creditor or counterparty of the company is harmed financially, will this mean that the relevant creditor or counterparty has no recourse at all, even in the form of a provable unsecured claim? Or will the Bank of England accept liability?

Q4: Do you have any comments on the intention to require the Bank of England to consult with the Financial Conduct Authority prior to seeking an administration order or directing administrators where regulatory overlaps may occur?

3.13 For any company facing the prospect of insolvency, speed and clarity are essential to preserve assets (both client and non-client), and value. Any interactions between the Bank of England and the FCA need to be clear and should be concluded within a set deadline to ensure all parties can plan for any impending insolvency.

3.14 Furthermore, R3 notes that the Government considers it appropriate for the Bank of England to consult the FCA before it directs administrators with regards to the regime's objectives. Again, the prospective/proposed administrator should be included in these discussions between the Bank of England and the FCA.

4. CONCLUSION

4.1 The development of an appropriate framework for DSA firm failures is welcome. However, as outlined above, several questions remain that require clarity, in order for the proposals to effectively achieve the desired outcome. Furthermore, one of the key practical issues that any regulation will need to resolve when the financial stability objectives are being pursued is the availability of funding in the administration to pursue the objective and how the administrators manage their personal liability.

4.2 If you would like to virtually meet or if you have any other queries, please contact R3's Head of Technical, Ben Luxford, at ben.luxford@r3.org.uk or on 020 7566 4218.

Yours faithfully

Ben Luxford
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R3, the insolvency and restructuring trade body

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