Investment Management Association

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**PROBLEMS REVEALED BY THE LEHMAN COLLAPSE**

The collapse of Lehman Brothers International (Europe) on Monday 15th September and the subsequent events revealed significant weaknesses with the default arrangements in the cash equity markets. This paper sets out the IMA's initial analysis of these issues. While further work is needed to establish the correct solutions, we consider that this work needs to be carried out as a matter of urgency, because the same problems would arise in the event of default of another broker.

When LBIE collapsed, many investment managers had trades outstanding with its brokerage business which did not settle. The result was that client portfolios would be affected by market movements after the trades were supposed to have been completed, with unclear liability for any associated losses, and a need to settle outstanding positions with the LBIE administrators. But the complexity of the LBIE administration is such that these will take a very long time to resolve, creating uncertainty which is contrary to the interests both of investors and of the market

The problems arise in large measure as a consequence of changes brought about by MiFID. Before MiFID, equity market trades in the UK had always been subject to exchange rules and protocols. In the light of fragmentation of trading venues following MiFID, it is all but impossible for an investor to know what a broker has done with his equity trades, and hence whether he will obtain the benefit of default rules for organised markets or be thrown back on contractual arrangements..

In contrast, when entering into OTC derivative contracts, the parties know that the arrangements are bilateral and outside the valuable default protections offered by exchange-traded and centrally cleared markets. As a result of this, investors know they must take extra measure to protect themselves. Conversely, on organised markets investors ought be able to expect that default rules and exchange protocols will protect them. No investor should have to wait months, possibly years, to obtain certainty about trades conducted through a UK authorised broker in UK listed shares and placed in the UK.

Other factors however predate MiFID and result from long standing features of the cash equity markets to which IMA has previously drawn attention. For example, LBIE did not distinguish trades of investment management clients from its own proprietary trading. Client trades, unlike inter-dealer trades across the exchange's order book, thus became part of the administration of the firm.

## Default rules of the exchange

A major part of the problems resulted from the inability of anyone – exchange, investors, administrators – to determine which transactions were subject to the

65 Kingsway London WC2B 6TD
Tel:+44(0)20 7831 0898 Fax:+44(0)20 7831 9975
www.investmentuk.org

exchange default rules. (Of course, no investors gained the benefit of the London Clearing House's default rules owing to LBIE's choice to operate only a proprietary non-segregated account at the clearing house.)

## **Part VII insolvency provisions**

The LBIE administration revealed that the default arrangements operating within the London Stock Exchange did not work to benefit investors. Whilst the principal purpose of the Companies Act Part VII insolvency carve out is to ensure market stability, the consequential and necessary impact is to ensure a swift and fair conclusion of outstanding contracts across the market. This did not happen. The reason that it did not happen, at least initially, was because Lehman had chosen to operate only a proprietary, non-segregated account behind its exchange-traded contracts. Thus, although the cross-market inter-dealer contracts were settled within the Part VII arrangements and concluded within the week, investor contracts were excluded and thrown into the general administration. Several months on, these contracts remain in a state of flux.

## **Settlement**

Shortly after LBIE went into administration, investors discovered that all their LBIE-related equity transactions held within Euroclear/CrestCo were frozen. In circumstances in which the usual exchange default process would be denied to investors, it became clear that investors would be reliant on the protection of the DVP (delivery versus payment) mechanism embedded in the UK equity market settlement system. The freezing of the trades therefore presented a critical problem to firms whose only protection was held within the locked-up mechanism.

The lock-up of the UK equity settlement system involving Lehman trades continued for 9 weeks. This in itself represents a systemic failure. But it also acted to undermine certainty of contract throughout that period and left investors with no clear course of action to take as the default progressed. To make matters worse, all this occurred at a time of extreme market volatility.

Institutional investors do not hold client cash. This is held at a custodian, generally appointed by the underlying client. Custodians act in response to properly delivered settlement and payment instructions following trade confirmation. Custodial arrangements are designed to ensure that, as best as possible, the client's position, and assets, remain well protected at all times throughout the trade clearing and settlement process.

However, because of the lock-up of the settlement system, the arrangements designed to protect the client acted instead to undermine the client's ability, through his agent the asset manager, to protect himself in the market. Many managers acted to repudiate contracts with Lehman with the intention of re-executing the trades in the market. But from the custodians' perspective, the transactions frozen in Euroclear/CrestCo were, in the absence of actual settlement or of a settlement failure, still valid. The custodians were not therefore in a position to release either cash or assets to the managers to allow them to effect further market transactions in respect of repudiated contracts. This left a large number of investors exposed to market risk with no way to hedge it since what was needed was to re-execute and for many of the most volatile shares, shorting was of course banned.

In the absence of clear information from the authorities, institutional investors had to spent much time and money attempting to establish the position on their trades and there is still no certainty despite productive and collaborative meetings that have since taken place with the joint administrators.

Systems do not lock up of their own accord – they do so on instruction. We remain unclear as to why this happened and at whose initiative. Our understanding of the UK settlement mechanism for equities is that transactions within the system will at a certain point in time become irrevocable, notwithstanding a subsequent insolvency. The necessary conditions include a committed delivery of property on the one side and a locked-in payment on the other from a settlement bank. Investors do not understand why a number of the transactions did not proceed, having passed the critical point. Equally, investors are at a loss to understand why the usual mechanism for settlement fails did not occur in relation to all transactions which had not reached the critical point at which they would become irrevocable. It is not clear what became of the role of the settlement banks, who were supposed to play a critical role in the operation of the CrestCo system.

We understand from conversations with various parties that it was believed that the impact of the Settlement Finality Directive had to be considered before instructions within CrestCo could be deleted. We do not understand why this should have led to thousands of failed trades and we would urge that the actions taken and the reasoning behind them should be made public. Transparency with the industry is an important part of restoring certainty and confidence in the existing framework, and in identifying where change may be needed..

## Terms of business

There is currently no clarity about the contractual arrangements in the UK equity markets between investors and brokers. The IMA has sought to mitigate this failure by preparing model terms for use across the market, although there has been resistance from the broker side of the market, which declined to engage on the wording of the terms, but agreed only to discuss in general terms some of the issues.

The LBIE collapse highlighted once more this gap in market arrangements. Since the collapse, however, IMA members report that the broker community has become even more demanding in respect of the terms they will accept from clients. This reinforces our view that contractual arrangements are no substitute for properly structured market arrangements. There is a need to address the imbalance in the relationship between asset managers and brokers. It is essential that the underlying clients, both institutional and retail, do not continue to suffer disadvantage through the mismatch in obligations owed by the broker to his immediate client.

There is a further serious investor protection point, which was dealt with in the model terms but resisted by many brokers. Managers find themselves in a situation where brokers (acting as “introducing brokers”, to use FSA terminology) may pass client orders without further liability, at least under their own terms of business, to another counterparty. The asset manager, who is acting as the agent of the underlying client, will usually have no legal agreement with the other party, and will rarely have chosen to trade with it. We have always considered this one-sided and non-transparent course of action to be problematic, as do our members. They will usually be unaware of the transfer of the trade until the settlement details come through, a day or so later. Nonetheless, it is common practice in the market and leaves the investor in the invidious position of accepting an arrangement he has not consented to, or running market risk by attempting to reject and re-place the trade. This is of course made worse by current turbulent markets.

## Client monies

We have major concerns about the handling of the client money accounts maintained by LBIE. Client monies are held in trust, and should thus have been outside the assets and operations of LBIE itself. It is true that the complexity of the Lehman business arrangements has inevitably made identification and distribution of client monies harder than in many insolvencies. But before the Financial Services and Markets Act 2000, collapses or other events which put client assets at risk were not uncommon and frequently were very complex. The SROs and SIB would rapidly take control over client assets, with SIB appointing trustees to secure them and ensure they were returned to customers.

Such steps were not taken in the LBIE case, indeed arrangements for client funds were not announced until 4 weeks after LBIE went into administration. We believe this did not work in the best interest of clients. We consider that the FSA should adopt such procedures in future insolvencies of brokers. It is unclear whether the FSA's powers under the Financial Services and Markets Act 2000 are sufficient to secure this; if not it should be given the appropriate powers.

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