

Foreword

Events in recent years have demonstrated regrettably that we have to be prepared for the possibility of major operational disruption in the financial system. Effective planning and preparation are crucial; the question of whether new statutory powers might be needed to handle the aftermath of these events is an important element of such preparation. The Task Force I was asked to chair has, since the summer, looked carefully at the range of complex issues relevant to deciding whether such powers would be helpful.

The balance of all these arguments has led us to the belief that new powers would not in fact be helpful. This is a view that we have reached after considering the responses to HM Treasury's Green Paper and after careful discussion with a range of public and private sector parties. Importantly our work drew on input both from the markets and from the legal profession, in particular on the excellent work of the Financial Markets Law Committee which published its own report today.

The Task Force covered much ground in reaching its conclusions. Underlying them were three generic issues. Firstly one needs to consider the likely conditions if an event of this nature were to occur. Apart from communication problems there could be confusion, distress, and an inability to conduct decision-making in a normal environment. This places a premium on having taken necessary measures in advance that will provide some element of predictability in coping with the problems. A fundamental difficulty about new powers is that in order to use them, further decisions would have to be taken at an already difficult time as to how they might be deployed or whether they were justified, and yet the actual process for taking such decisions could be in disarray.

Secondly, we were struck by the evidence of the way in which communities have coped with crises of one sort or another when they do actually strike. In New York, for example, after the sad events of 9/11, there was an overall determination on the part of all the participants to act pragmatically with the common purpose of getting the system up and running again as fast as possible. The initial instinct was above all to get moving again, without the need to have to focus on complex legal issues. Naturally one cannot rely on such mutual support under all circumstances. However, we think it is fair to place some reliance on this. A combination of the need for simplicity and to act in a pragmatic manner in times of difficulty has weighed in our conclusions.

And thirdly we need to consider the international environment in which we operate. In today's wholesale financial markets, contracts increasingly straddle national boundaries and transactions have legs in a number of jurisdictions. Consequently, an attempt to assert powers which would bear on the single jurisdiction of the UK, could in fact give rise to additional problems rather than adding to predictability or assisting due performance of contracts within the UK.

I would like to stress, however, that our conclusions that new statutory powers are not needed does not leave room for complacency. Statutory powers are just one element of the necessary response package, which involves a number of complementary and inter-linked measures. A large amount has been done to mitigate problems. But there are still some areas where more needs to be done, and our conclusions were based on the premise that more would be done. Accordingly we have made a series of recommendations together with suggestions as to how and when they can be implemented. It is important that they are followed up. I am pleased that the Tripartite Standing Committee on Financial Stability will take on the task of monitoring progress in meeting these recommendations and will report in October 2004.

This has been a significant exercise, demonstrating the necessary interaction between the public and private sector. I would like to thank the members of the Working Groups, and in particular the three chairmen, as well as those we have consulted more broadly who have devoted considerable time to this important subject and facilitated this dialogue. I hope that this cooperation continues as we work together to meet the recommendations.

Sir Andrew Large

Chairman

Task Force on Major Operational Disruption in the Financial System

3 December 2003

Executive summary

E.1 The objective of the Task Force was to examine whether there was a case for new legislative responses to deal with the threat of major operational disruption in the UK financial system. Building upon HM Treasury's Green Paper and the responses to it, the Task Force examined the need for:

- powers to suspend financial obligations;
- powers of direction over financial markets;
- powers to prohibit financial transactions;
- powers to declare a bank holiday;
- emergency powers under the Civil Contingencies Bill; and
- powers to waive statutory requirements during a crisis.

E.2 The Task Force concluded, on balance, that no new statutory powers are needed. It acknowledges the importance of the existing focus on contractual methods of dealing with emergencies, on market infrastructure rules, and on creating an environment where there is a co-ordinated approach to contingency planning. The conclusion was reached following a detailed analysis, by the Task Force and its three Working Groups, of a range of complex legal issues. This report summarises the Task Force's findings. Further background on the study and the Working Groups' individual reports can be found in the Annexes to this report.

E.3 In reaching its conclusion the Task Force considered whether an extension of statutory powers would add usefully to existing arrangements for dealing with operational disruption — in particular, whether it would:

- maintain incentives for market infrastructures and participants to plan for business continuity¹;
- help keep markets open;
- increase legal clarity;
- enable the orderly resumption of financial markets;
- build on market-based solutions wherever possible; and
- use established decision-making processes where possible.

E.4 An essential foundation for this analysis was the identification of certain key features of the London markets:

- their scale and complexity, which suggests that those closest to the markets are likely to be in a better position to understand the impact that a decision in one area might have on others;
- the speed of structural change in markets, which means that statutory responses from the public authorities risk becoming out of date quite quickly; and
- the speed with which markets react to events, which means that decisions have to be taken in a flexible manner.

Given these characteristics, the Task Force worked from the premise that, while the authorities have an important role to play, the primary responsibility for dealing with operational disruption rests with the financial markets themselves.

E.5 The Task Force noted the international and interconnected nature of many of the UK's financial markets and the need to ensure that approaches taken in the UK were compatible with those taken elsewhere. This was an important factor in considering the potential impact of statutory powers.

E.6 Having clarified its objectives and assessed relevant aspects of the financial environment, the Task Force reviewed the measures already in existence to minimise the impact of major operational disruption. In particular, it sought to identify the extent to which provisions in private sector contracts and in the rules of market infrastructures represented best practice and were actually implemented.

E.7 In respect of the first, a wide range of defensive measures and risk management provisions can be used to help mitigate the consequences of major operational disruption. Although the provisions vary from contract to contract, this should not be seen as a weakness, rather as reflecting differences in the characteristics of markets and in the contracting parties' priorities. For example, although *force majeure* provisions may provide a useful mechanism for addressing the impact of major operational disruption, their inclusion in contracts is not always appropriate and their absence should not *per se* be seen as a cause for concern.

E.8 The Task Force concluded that the contractual risk management mechanisms currently available generally allow contracting parties to address and

¹ In this report the word "infrastructure" is used to denote financial market infrastructures such as stock exchanges and not to physical infrastructure such as electricity or telecoms infrastructure.

manage risks appropriately, though it makes some suggestions for improvement as to how these are implemented. This conclusion is in line with the outcome of similar reviews in the US.

E.9 In respect of the second, it examined whether key market infrastructures — payment systems, exchanges, clearing and settlement systems and financial infrastructure service providers — have suitable rules in place to deal with major operational disruption. UK infrastructures generally appear to have well-developed plans for business continuity, with a range of powers within their rules to deal with major operational disruption. These are principally triggered by broadly drafted *force majeure* clauses or similar provisions that allow for specific steps to be taken in crisis situations. These powers include the power to amend rules, to suspend trading, clearing or settlement and to suspend participants. Some infrastructures have “catch all” powers to take any appropriate action in a crisis.

E.10 The Task Force concluded that the rules which market infrastructures have in place to deal with major operational disruption are on the whole sufficient, though it also makes some suggestions for improvement.

E.11 It was against this background that the Task Force examined whether new or amended statutory powers might be needed. In doing so, it considered whether there were any identifiable gaps in existing powers, whether the potential remedies were feasible to implement, and whether they would help to promote clarity and legal certainty.

E.12 The potential benefit of a **power to suspend financial obligations** would be to provide a “breathing space” for markets in the immediate aftermath of major operational disruption by deferring certain legal and financial obligations. Aside from any other objections to a general power of suspension, however, the Task Force found that there were significant difficulties in being able to clarify, with the required level of precision, the obligations which would be subject to the power (even if the power were to be exercised only on a temporary basis in extreme conditions). Moreover, in internationally-interconnected markets it is difficult to treat obligations in isolation. Many obligations are connected to others — such as in hedging contracts (which may be subject to the laws of another jurisdiction) — and there would be practical problems if some obligations were suspended while other related ones were not. In such circumstances, intervention

could compound the problems created following major operational disruption rather than reduce them.

E.13 A **power of direction over financial markets** — to order closure or to modify rules — would not suffer the same definitional problems, but its efficacy would be limited if it applied only to UK-based infrastructures, when many transactions which “occur” in UK markets rely on infrastructures based overseas.

E.14 A **power to prohibit financial transactions** would go beyond the powers envisaged by HM Treasury in the Green Paper, and would also raise similar definitional issues and limitations as are referred to above in the context of powers of suspension.

E.15 A **power to declare a same-day bank holiday** could be beneficial by signalling to market participants that the day in question was not to be treated as a normal business day. Similar benefits can, however, be obtained by informal means, such as by a statement from the financial authorities; and this might also avoid the practical confusions about the “traditional” aspects of bank holidays eg whether there was, or was not, an expectation that staff would receive an additional day of paid leave. The legal consequences of declaring a bank holiday are not straightforward. It might require market infrastructures to close where they had defined their business days in relation to bank holidays, when the objective should be to keep them open wherever possible.

E.16 The **emergency powers in the Civil Contingencies Bill** which is due shortly to be introduced into Parliament would be available where there is a declaration of a state of emergency. These powers would be capable of being applied to the financial services sector, though the Task Force could not readily identify ways in which they might be used constructively to deal with the legal issues surrounding major operational disruption considered in this report.

E.17 A **power to waive statutory requirements during a crisis** is not necessary. The FSA has already made provision that a person will not be in contravention of its rules when compliance with those rules is impracticable as a consequence of an emergency.

E.18 The Task Force concluded, on balance, that no new statutory powers are needed. It prefers to rely on the existing approach adopted by market participants and the financial authorities, namely to focus on

contractual methods of dealing with emergencies, and on appropriate market infrastructure rules, against a background of co-ordinated contingency planning. It believes that this approach is best suited to the particularly international and interconnected nature of UK markets. It recognises the fact that the laws of countries other than the UK also govern contracts in London's markets, which would not, or might not, be subject to the provisions of UK legislation.

E.19 The Task Force's conclusions are in line with the approach taken by the US authorities following 11 September 2001. They minimise the risk that the exercise of new powers would be incompatible with rules prevailing in other major financial centres and the risk of new powers impeding rather than promoting the orderly resumption of financial markets.

E.20 The Task Force's conclusions are also in line with those of the Financial Markets Law Committee's (FMLC) Emergency Powers Legislation Working Group which found that there were no significant legal gaps which required new legislation. The FMLC report describes many of the issues dealt with here in further detail.

E.21 The conclusion that no new statutory powers are needed is based not only on the work that has already been undertaken to address business continuity issues but also on the need for further improvements. In particular, the Task Force has put forward eight recommendations to help further improve the resilience of UK financial markets:

Recommendation 1: *Market participants and the financial authorities should continue to place a high priority on business continuity planning.*

Recommendation 2: *Market participants and their trade associations should work to ensure that private contracts are reviewed to take account of major operational disruption. A useful starting point for such reviews is the "contracts checklist" put forward in the FMLC's report on emergency powers.*

Recommendation 3: *Market infrastructures should ensure that they have specific rather than general powers to deal with major operational disruption. They should also ensure that the mechanism for invoking these powers is flexible enough to be operated successfully in a crisis.*

Recommendation 4: *The UK financial authorities should continue to contribute to international efforts to develop recognised good business continuity practice for systemically important market infrastructures. Their application in the UK should recognise that the prime responsibility for business continuity planning rests with the senior management of firms and market infrastructures.*

Recommendation 5: *Participants in significant markets should consider whether there would be benefits from further defining the principles on which to base claims arising from the delayed performance of contracts following major operational disruption.*

Recommendation 6: *The financial authorities should aim to clarify further, and publicise, their respective roles in the event of major operational disruption.*

Recommendation 7: *The financial authorities should consider with market participants the need for a high-level committee to help ensure co-ordination across financial markets in the event of major operational disruption.*

Recommendation 8: *The UK financial authorities should continue to promote international co-operation and co-ordination in developing responses to major operational disruption.*

E.22 For each recommendation, the Task Force has suggested how it could be implemented. It also proposes that the Tripartite Standing Committee on Financial Stability comprised of the three financial authorities — HM Treasury, FSA and Bank of England — should monitor progress in meeting the recommendations, and publish a progress report in October 2004 and annually thereafter.

E.23 Finally, it should be stated clearly that nothing in this report is intended to conflict with the wider overhaul of emergency powers being considered in connection with the Civil Contingencies Bill. Some events which could give rise to major operational disruption in the financial services sector could also give rise to urgent human and social requirements which would have to be addressed by the authorities using emergency powers.