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Dear Sirs

FCA CP14/23: Restrictions on the retail distribution of regulatory capital instruments

The City of London Law Society (**CLLS**) represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the **Committee**). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

1. BACKGROUND

The temporary product intervention

1.1 The FCA announced in August 2014¹ the use of its temporary product intervention powers in respect of ‘contingent convertible instruments’ (**CoCos**). In summary, CoCos are financial instruments that meet the requirements for AT1 or Tier 2 (T2) capital with write down feature (temporary or permanent) or a conversion feature to common equity, under the EU Capital Requirements Regulation (**CRR**).

¹ FCA Communication, ‘Temporary product intervention rules – Restrictions in relation to the retail distribution of contingent convertible instruments’ (August 2014) (<http://www.fca.org.uk/static/documents/temporary-product-interventions/restrictions-in-relation-to-the-retail-distribution-of-cocos.pdf>)

1.2 The rules effectively restrict firms from issuing and/or distributing CoCos (which include such instruments issued by mutual societies) to ordinary retail investors (i.e. those that do not fall within specified exemptions).

1.3 The temporary intervention on CoCos was made under s.138M of the Financial Services and Markets Act 2000 (**FSMA**), which did not require consultation or compliance with certain other FSMA requirements (e.g. a cost-benefit analysis).

1.4 Temporary rules are limited to a maximum duration of 12 months. The temporary rules on CoCos expire on 1 October 2015.

What is being proposed in Consultation Paper 14/23?

1.5 The FCA is consulting in CP14/23² on permanent rules to replace the temporary rules relating to CoCos. It is proposed that these rules will be made under s.137D FSMA, on the basis of advancing the FCA's consumer protection objective. It is worth noting that the FCA is proposing to carry through the scope of the prohibition which reads (draft COBS 22.2.1R) "A firm must not sell or do anything else that would or might result in a retail client in the EEA buying...".

1.6 The 'catch all' nature of the rule is perplexing and there is a genuine concern with this scatter gun approach that could render firms in non-compliance whilst not having a reasonable element of foresight on how their conduct could be caught. For example, a firm effecting an introduction between a wealth manager and the lead manager of a CoCo transaction could be implicated should the outcome be a mis-selling. This broad language stands contrary to the principle that compliance with rules must be practically possible and is capable of being clearly understood by the person subject to the rule so that he has a reasonable notice of its existence, scope and effect.

1.7 Additionally, the proposed new permanent rules seek to impose certain requirements on firms seeking to distribute 'mutual society shares' to ordinary retail investors in the context of a primary issuance.

1.8 'Mutual society shares' are, in summary, financial instruments that meet the requirements for common equity Tier 1 capital (CET1) under Article 28 or 29 CRR and are issued by an institution listed in Article 27 CRR.

CoCos

1.9 The FCA considers CoCos to be highly complex, presenting investment risks that are exceptionally challenging to evaluate, model and price.

1.10 The FCA's intervention against CoCos is consistent with the spirit of the European Securities and Markets Authority (**ESMA**), as articulated in its July 2014 statement on risks associated with investing in CoCos, which concluded that the analysis required to "*fully understand and consider the risks of CoCos and correctly factor those risks into their valuation... can only take place within the skill and resource set of knowledgeable institutional investors.*"³

² CP14/23, 'Restrictions on the retail distribution of regulatory capital instruments' (October 2014) (<http://www.fca.org.uk/static/documents/consultation-papers/cp14-23.pdf>)

³ ESMA Statement 2014/944, paragraph 6 http://www.esma.europa.eu/system/files/2014-944_statement_on_potential_risks_associated_with_investing_in_contingent_convertible_instruments.pdf

Mutual society shares

1.11 In CP14/23, the FCA considers ‘mutual society shares’ to be complex, risky and posing a significant risk where distributed to non-sophisticated investors.

1.12 Nevertheless, the FCA has determined that a proportionate response to remedying the risks posed by these products is achieved through mandatory disclosure of specified risk warnings and obtaining client acknowledgement of risks.

1.13 The FCA’s policy conclusion is in stark contrast to its conclusion for CoCos. For CoCos the FCA has argued: “*we do not consider that other solutions, such as additional disclosure, are likely to be sufficiently effective in this sector, or to have a more positive impact on competition, given the need for specialised knowledge and the highly complex, unfamiliar, and untested, nature of these securities*” [emphasis added].

2. MUTUAL SOCIETY SHARES - INCONSISTENCIES IN THE FCA’S APPROACH?

2.1 The FCA makes the point that neither CoCos nor mutual society shares are created to meet a “*consumer need*”, as the focus is on the issuer’s prudential requirements.⁴ However, a similar view could be taken in relation to ordinary equity shares (also capital raising instruments) - the issuance of shares has never been designed to meet a “consumer need”.

2.2 The core characteristics of mutual society shares can be argued as being no different from those of ordinary equity shares (also CET1) issued by other financial services institutions. This reasoning is supported by the FCA’s statement that many of the risks regarding mutual society shares “*are similar to those applicable to direct investment in company shares, [and] it is worth noting that direct investment in shares is generally risky.*”⁵

2.3 It is long accepted that ordinary retail investors have the requisite sophistication and skill to assess the risks associated with purchasing shares in a bank – even where the issuance is to them in the primary market. As ordinary equity shares and mutual society shares are materially similar, both in terms of risk profile and purpose (as capital raising instruments), it does not seem consistent, rational or proportionate to discriminate against mutual society shares.

Not consistent with the scope of the European proposals

2.4 Both the recent communications of ESMA and the joint European Supervisory Authorities (**ESAs**)⁶ focused solely on CoCos.

2.5 Nevertheless, the FCA appears to have treated mutual society shares as somehow akin to CoCos, stating that “*as with CoCos, we are concerned that these securities are hard for investors to value and that their features may not fit naturally with the needs of ordinary retail investors.*”⁷ By extending restrictions to mutual society shares, the FCA’s proposed intervention goes beyond the intentions of ESMA and the Joint Committee of the ESAs, .

⁴ CP14/23, paragraph 3.2

⁵ CP14/23, paragraph 3.9

⁶ JC 2014 62 http://www.esma.europa.eu/system/files/jc_2014-62_placement_of_financial_instruments_with_depositors_retail_investors_and_policy_holders_self_placement.pdf

⁷ CP14/23, paragraph 1.18

Impact on mutual sector

2.6 Under s.138K FSMA, the FCA is required to provide an opinion on whether the impact of proposed rules on mutual societies is significantly different from the impact on other authorised persons. In the Public Bill Committee on the Financial Services Bill, the Financial Secretary to the Treasury elaborated on the rationale behind this provision regarding mutual societies:

“...there are situations, such as those around capital, for example, where what might be appropriate for a bank might not be appropriate for a building society or a credit union because of their mutuality. That is an important part of clause 22 [which introduced the new s.138K FSMA]. It requires the FCA and the PRA to give more explicit consideration to the impact on mutuals than the FSA does at the moment. There is a widespread concern among the mutual movement that the FSA does not spend enough time thinking about the impact of its regulations or rules on mutuals. The provision helps to redress the balance... It is a coalition commitment to promote diversity in ownership of financial services firms, including mutuals” [emphasis added].⁸

2.7 In CP14/23, the FCA acknowledges that mutuality precludes mutuals (such as building societies) from raising capital by issuing ordinary equity shares. This presents a particular challenge and arguably places such institutions at an immediate disadvantage as regards raising regulatory capital.

2.8 However, the FCA is proposing to place restrictions on mutual society shares (CET1 capital) which will constrain the primary market in such instruments and reduce their liquidity. Illiquidity will naturally weaken demand for the instruments and consequently affect their value as a capital raising instrument.

2.9 It is inconsistent with the efficient functioning of the financial services sector to create distortions that frustrate the ability of mutuals to raise regulatory capital. It is likely that such action will hinder diversity in financial services.

Conclusion

2.10 The FCA's proposed restrictions on the distribution of mutual society shares to retail investors are premised on the grounds of consumer protection. However, a number of the features of the restrictions seem to undermine the ultimate goal of protecting 'consumers'.

2.11 We consider that the FCA's proposed intervention measures, with regards to mutual society shares, will:

- (a) reduce the ability of mutual societies to raise capital using the instruments;
- (b) reduce the market demand for such instruments;
- (c) increase the cost of raising capital using such instruments;
- (d) hinder the development of liquidity in the instruments; and

⁸ Public Bill Committee Debate (Session 2010-12), 'Financial Services Bill' (8 March 2012) (<http://www.publications.parliament.uk/pa/cm201212/cmpublic/financialservices/120308/pm/120308s01.htm>)

- (e) increase the risks for those retail investors who do choose to hold such instruments (due to hindering growth in their liquidity and product innovation).

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact either Peter Richards-Carpenter by telephone on +44 (0) 20 3400 4178 or by email at peter.richards-carpenter@blplaw.com, or Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at Karen.Anderson@hsf.com in the first instance.

Yours faithfully

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ANNEX 1

CONDITIONS FOR THE EXERCISE OF PRODUCT INTERVENTION POWERS

1.1 The FCA, under s.137D FSMA, may make product intervention rules where it appears “necessary and expedient” for the purpose of advancing its consumer protection objective or its competition objective.

1.2 In PS13/3 factors the FCA would consider when making temporary product intervention rules were detailed. These include general, contextual and competition considerations.⁹

General considerations

1.3 In general terms, in making product intervention rules, the FCA will “*consider a product intervention rule where it identifies a risk of consumer detriment arising from a particular product, type of product, or practices associated with a particular product or type of product.*” In making such rules, the FCA will have regard to general considerations, which include whether the proposed rules are:

- (a) an appropriate and effective means of addressing actual or potential consumer detriment associated with a particular product or group of products;
- (b) a proportionate and deliverable means of addressing actual or potential detriment;
- (c) compatible with the FCA’s duty to promote effective competition in the interests of consumers (s.1B(4) FSMA);
- (d) supported by sufficient and appropriate evidence;
- (e) transparent in their aim and operation; and
- (f) likely to be beneficial for consumers, when taken as a whole.

1.4 In addition, the FCA will consider the risk that the rules have a negative impact on protected groups in the Equality Act 2010 and whether the rules can promote equality and good relations.

Contextual considerations

1.5 The FCA will take into account the following contextual considerations in response to an identified product-centred issue:

- (a) the potential scale of detriment in the market – issues involving products with a large or potentially large customer base are more likely to require product intervention;
- (b) the potential scale of detriment to individual customers – issues that may lead to high detriment for individual customers are more likely to require product intervention;

⁹ PS13/3, paragraphs 19-25

- (c) the social context – issues that may lead to detriment for particular groups of customers (such as, in particular, vulnerable customer groups) are more likely to require product intervention;
- (d) the market context – market mechanisms such as information disclosure and competition do not always work to protect consumers; and
- (e) possible unintended consequences – whether the use of product intervention rules or the timing of the intervention would in itself create undue risk of further consumer detriment, including harm to existing customers in the market (although this will not necessarily comprise a full cost benefit analysis).

Competition considerations

1.6 The FCA will also seek to promote effective competition in the interests of consumers. In doing so, it will take into account the following considerations:

- (a) whether there is reasonable scope for the rule under consideration to promote effective competition in the interests of consumers, for instance by addressing consumer behaviours that impair their ability to benefit from competition, by reducing information asymmetries or by correcting misaligned incentives;
- (b) whether the rule under consideration may have a negative impact on competition factors such as product innovation and barriers to entry for new market participants;
- (c) whether any negative impact on competition factors is proportionate, having regard to the aims of the rule under consideration;
- (d) whether alternative solutions may deliver the same intended outcome while having a more positive impact on competition; and
- (e) the overall effect of a proposed rule upon the operation of effective competition in the market for financial services, having regard to the interests of consumers.