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Dear Roslyn

FSA Consultation CP09/12: Quarterly Consultation

The City of London Law Society ("CLLS") represents approximately 13,000 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 17 specialist committees. This response has been prepared by the CLLS Regulatory Committee. Members of the CLLS Regulatory Committee (the "**Committee**") advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

We comment on two aspects of CP09/12 : the proposed revised PERG guidance on "arranging" (Chapter 6) and the proposed new guidance on packaged structured investment bonds (Chapter 7).

We appreciate that you intend to alter the current PERG guidance, however the interpretation of Article 25 (2) is notoriously difficult and the current guidance, even in its amended form, is not particularly extensive. We do not think that small changes should be made to the existing guidance as is proposed, we consider that there should be a fuller review of issues related to Article 25 (2) and more comprehensive guidance. We think that the changes proposed raise many wider issues which ought to be considered carefully prior to the adoption of any amendments. The regulated activity of 'arranging' , in particular under Article 25 (2), is one on which there is no consensus amongst legal practitioners or the courts, and therefore the scope of the current PERG guidance is uncertain; the definition of 'arranging' in the current PERG

guidance is unclear and unhelpful. We would very much welcome engaging in more detailed discussion with the FSA on this issue.

Arranging: PERG 2.7.7.B G

Preliminary observation – the Watersheds case

We are concerned that no mention is made of the recent High Court decision in Watersheds (Case No: HQ06X02904, High Court, Queen's Bench division, judgment of 13 February 2009, (not yet freely available)). Indeed, we surmise that the proposed amendments are in part a response to that decision, especially to the judge's reading of PERG 2.7.7BG as it now stands and possibly also a response to Re Inertia Partnership LLP [2007] 1 BCLC 739. We are not surprised if FSA considers that the judge's remarks at para 68 of Watersheds give an exclusionary effect to the passage quoted which was not intended by FSA. We also note that his remarks at para 69 involve an unusually wide interpretation of the meaning of the exclusion in Article 27 of those merely providing a means of communication.

The effect of the amendments to PERG is to contradict the impression that PERG construes article 25(2) as being concerned with the "provision of facilities for others as opposed to "assisting one party". But that impression, received by the judge, has been given the force of law in his judgment. However much FSA may disagree, it is not possible for PERG to ignore the decision. Even if the FSA considers that the judgement rests on a "mistaken" reading of PERG, corrective changes to PERG cannot neutralise the judgment, even if new guidance may persuade the court in a future case that Watersheds was wrongly decided.

The amendments proposed are therefore somewhat misleading in the absence of a discussion of the case or at least the fact situation. We suppose that it is open to FSA to state that it disagrees with the judge's conclusions and is confident enough to press for a different view in future court proceedings. But those whose perimeter status may be affected by the Watersheds decision deserve to know of the fact that the FSA intends to make such a challenge.

In the light of the case, our comments below are offered on the assumption that FSA will acknowledge that Watersheds has changed the law, at least temporarily, but FSA will nonetheless take perimeter enforcement action on the basis that the case was wrongly decided on the article 27(2) point.

Comments

The scope of article 25(2) of the RAO is notoriously uncertain and, as practitioners, we are aware that FSA has traditionally taken a broad view of its extent. Whilst we do not necessarily agree with FSA's interpretation in every case, we do think it helpful for PERG set out a clear statement of FSA's position, especially as our impression is that many firms and practitioners are not aware of FSA views. The very brief discussion of art 25(2) in the existing PERG 2.7. hardly amounts to a clear interpretative commentary, as was borne out in Watersheds.

We therefore welcome in principle the expansion of the PERG guidance, but consider it could be improved in three respects:

1. It is not clear to us (and by implication even less so to an industry readership) what the following passage is intended to cover:
"It is of note, however, that this regulated activity is not limited to arrangements that are participated in by investor – neither is it necessary that both parties participate in the

arrangements. So, arrangements may come within the activity if they are participated in only by product companies with a view to their issuing investments"
Who are the "both parties" referred to? Does this mean "both parties to a transaction"? What is an example of arrangements participated in "only by product providers …"? (Presumably, one example would be arrangements with introducers.) More specific detail would be helpful.

2. Other useful commentary on article 25(2) is to be found in other parts of PERG and elsewhere. Although PERG 5.6 (insurance intermediaries) is cross-referenced at PERG 2.7, it would be helpful if the main PERG 2.7 guidance could refer expressly to:

   (A) the distinction between introducing and passive advertising made in PERG 5.6;

   (B) the importance of the "purpose" of the arrangements in assessing whether they are caught by art 25(2), discussed at PERG 8.3.2G in connection with newspaper and internet financial services advertising; and

   (C) the discussion in Guidance Release 3/98, para 19 of what activities relating to the raising of corporate finance may constitute "arrangements with a view to transactions", updated for any changes since its release. It is worth mentioning that had the relevant part of PERG followed this earlier approach to giving detailed and fully argued guidance of the kind found in that guidance release, with legal explanation, rather than vague comments, the judge would have found it very easy to understand the views of the FSA.

3. In one other respect the brevity of the proposed amendments and lack of argument/explanation leads us to be uncertain of the meaning of the proposed guidance. Is the change in the last sentence of 2.7.7B now intended to indicate that Article 25(2) arrangements can only exist where the person concerned is doing something which is "necessary to ensure that" a transaction is brought about? If so it seems that the distinction between Article 25(1) and Article 25(2) is very small, as both would involve something which in some way brings about the transaction. If that is not the intention of the FSA in making the proposed amendment we suggest that this should be made clear since the revised sentence could easily be read to have that effect.

Proposed PERG 16 : Packaged Structured Investment Bonds (PSIB)

We support the addition of guidance on this topic and (subject to certain reservations set out below) are broadly in agreement with the views expressed, although the draft is not always very clear and in certain areas creates uncertainty as regards a proper delineation between collective investment schemes (**CIS**) on the one hand and PSIB on the other.

Our main concerns relate to a lack of clarity as to how various key concepts of the CIS regime are interpreted (in the FSA's view) as applied to a typical PSIB. This is not helped by imprecise use of terms to describe investors' various interests in a PSIB and apparent restrictions as to the types of services that can be offered in connection with a PSIB. It may also be unnecessarily confusing to describe these instruments as "packaged" structured investment bonds when they are not "packaged products" and that term is also used to cover insurance company packaged structured bonds which are not addressed in this guidance.

In more detail:

- Q&A 4 - In what sense could a PSIB be “managed as a whole” by a putative operator? Presumably the danger of this activity being carried on is negated by the PSIB investor having ordinary ownership rights in a particular underlying investment. Throughout the Q&As the central question of whether there is any management at all in a passive buy to hold to maturity situation is not addressed with any clarity.

- Q&A 5 – Whether or not the operator of a scheme retains on-going responsibility in relation to the investments is irrelevant in the context of establishing a CIS, i.e. it is not a characteristic prescribed by section 235 of the FSMA (or any exemptions). The fourth bullet point is therefore misleading and should be deleted.

- Q&A 6 - What is the meaning of “day to day control over the management” of a passive investment such as PSIB? The draft guidance appears to equate this to ordinary proprietary ownership rights in the underlying product, including the right of transfer or sell the underlying investment free of the package structure. If this is a correct summary of the FSA view, it should be so plainly stated although we would argue that, given the complexity of an analysis of proprietary interests, it may create more uncertainty than clarity in identifying the correct nature of a particular scheme. In describing "day to day control over the management" Q&A 6 also suggests that investors will not have day to day control where the packager retains discretion as respects management of the underlying investments. However, PSIB frequently incorporate some measure of discretion on the part of the operator, for example in relation to the initial selection of the underlying investments. We do not see why discretion of this nature should indicate a CIS.

- Q&A 6 (penultimate bullet point) says “you [should ensure you] do not grant additional rights to investors”. It is not clear what is meant. Presumably not all rights would be indicative of a CIS; only those in the nature of pooled ownership rights or some additional benefit. Practical examples would be helpful (such as the treatment of the addition of guarantees). The Q&As appear to indicate that custodial and brokerage services would not be regarded as relevant but this is not made clear here, nor is it clear how other services, such as liquidity services, would be regarded.

- Q&A 6 – the final paragraph states that "if both the underlying bond and the issuer are identified to the investor at or before the time of sale that may point away from the arrangements being a collective investment scheme". We are of the view that this is irrelevant to characterisation as a CIS and is unhelpful in that (as acknowledged) plan managers quite frequently do not provide this level of disclosure. Irrespective of any policy issues thrown up by non-disclosure, the CIS definition is not the right tool to seek to regulate disclosure in this way.

- Q&A 8 - In what consists the crucial distinction between an “interest in the underlying bond” and “an interest in the arrangements as a whole”? Again, the former presumably means ordinary ownership rights but it is not clear what are the badges of the latter kind of interest (avoiding a highly technical analysis of the relevant terms). Q&A 8 seems to give a contradictory message on this point, saying (final paragraph) that “selling his interest in the underlying investments… has more in common with the right to sell his interest in the arrangements as a whole”. This appears to collapse the crucial distinction which has previously been made. Q&A 8 also states that management of the underlying investment by the packager may preclude day-to-day control of the same investment being solely in the

hands of the investors. This is not correct, as "management" and "control" are very different concepts, a point indeed made in the preceding sentence in Q&A 8.

- Q&A 15 refers to the debt securities exemption. This exemption was intended to address CIS concerns about securitisation structures, where the holders of bonds issued by corporate SPVs might be considered as participants in CIS arrangements of which the SPV is only a part, thus rendering the body corporate exemption inapplicable,. We do not think it is apt for PSIBs for this reason. If investors own the bonds in the PSIB structure then the need for an exemption probably does not arise. However we are concerned with two aspects of the draft guidance in Q&A 15. First, there is a suggestion that the issuer of the underlying bonds may be making CIS arrangements. Surely this is not so, if only because of the body corporate exemption. Secondly, we do not think it is technically correct to state that any additional rights enjoyed by investors under arrangements would deny the exemption in general. The phrase “rights and interests of the participants” refers back to section 237(2) of FSMA (the definition of “units”) and means the rights and interests in profit/income from the CIS – and not, for example, ancillary rights such as custody or administration.

In terms of minor, hopefully uncontroversial, drafting amendments, we note the following:

- we would suggest an amendment to the title of the chapter in the Perimeter Guidance such that it reads "Guidance on Packaged Structured Investment Products" rather than "Guidance on Packaged Structured Investment Bonds", given that several investment plans offer shares, rather then debt obligations. Consequential amendments would need to be made throughout (e.g. Q&A 3, where the defined term of a "bond" is introduced);

- please insert the words "management of the" before "underlying investments" in the second bullet point in Q&A 5 (for consistency with section 235(2) of the FSMA);

- we would suggest deleting categorical statements such as "in all circumstances" (see, for example, Q&A 6) given the wide variety of investment plans in operation as such statements do not allow for mitigating circumstances. Additionally, the current drafting of Q&A 6 does not actually guide a user as to what factors are helpful/unhelpful in making that determination;

- please clarify that the guidance set out in Q&A 9 applies equally where securities are held via a sub-custodianship; and

- please insert the words "investments which are" between "represented by" and "certain debt securities" in Q&A 15. This is simply to render the statement more accurate.

Please let us know if you wish us to clarify any of our responses.

Yours sincerely

Margaret Chamberlain
Chair CLLS Regulatory Committee

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