The City of London Law Society

4 College Hill
London EC4R 2RB

Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 - Cheapside 2

mail@citysolicitors.org.uk

www.citysolicitors.org.uk

Jason Pope
Conduct Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

Email: cp12_19@fsa.gov.uk

Submitted by Email

November 2012

Dear Mr. Pope

Re: FSA Consultation Paper CP12/19: Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes

Introduction

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.

This paper has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms in the financial markets, including alternative investment fund managers specialising in numerous strategies and asset classes such as hedge, private equity, real estate, listed equities and fixed income, as well as service providers such as depositaries/custodians, prime brokers and fund administrators.

As you will see from our detailed comments below we have very serious concerns about these proposals. We would very much welcome a meeting with the FSA to discuss them at the earliest opportunity.

Our concerns relate to a number of important issues including:

- The scope of the proposals, which includes the introduction of yet another categorisation of instruments into what is already a complex picture. The new definition is extremely wide, it creates serious legal uncertainties and risks being as poorly understood by regulated firms as the current definition of unregulated collective investment scheme. Indeed even their legal advisers will have difficulty with it. If the FSA wants to create a regime under which only certain products may be promoted then it would be better to do so by creating express categories that are included, rather than excluded. We do not though advocate such a solution, indeed we see no policy need for it or the current proposal. If there is a concern about a particular product the response should be aimed at that.

- The driving force behind the proposals seems to be a number of specific enforcement cases without consideration of the broader market which may be covered by the uncertain definition. We consider that it would be more proportionate for the FSA to focus on improving the training standards of firms which give advice as is being done under the RDR, and identifying and disciplining firms which give unsuitable advice, rather than depriving all private investors from access to products which may be suitable for them. If there is concern about a particular competence the regulatory response should be aimed at that, (for example, restricting advice on unregulated CIS unless the adviser holds a suitable qualification).

- We say "all private investors" because there is little recognition in the paper that the exemptions which permit promotions to be made to sophisticated and high net worth investors are narrow. It appears to us that most of the investments caught by the new definition could not be promoted even to these investors, depriving them of access to some investments which might be very suitable for them in the context of their overall portfolios.

- We suggest that if the proposals are advanced in any form the FSA will need to create a new category of customer who can afford proper advice and enter into fully advised transactions. We do not see why customers should be forced into a discretionary management service in order to invest in a wider range of assets, if they prefer the control and independence that can be achieved through an advisory relationship.

Comments

1 We are concerned that there will shortly be a series of overlapping and uncertain definitions in the same area, each of which lack legal certainty, namely:

(a) "unregulated collective investment scheme" ("UCIS") by reference to the notoriously uncertain definition of a "collective investment scheme" under s 236 FSMA. This is relevant both for generating an authorisation requirement for the "operator" and for restrictions on promotion even by FSA authorised firms under ss 238 and 240 FSMA. So uncertain is this definition that it is only made workable by the

provision of a number of specific exemptions under the FSMA (Collective Investment Schemes) Order 2001, such as those for employee share schemes and ordinary closed ended companies;

(b) "alternative investment fund" ("AIF") under the Alternative Investment Fund Managers Directive. This will be relevant for generating not only an authorisation requirement for the "AIFM" but also extensive and detailed obligations relating to the way in which the AIF is run and will provide a "passport" for marketing AIF to professional clients (as defined under MiFID) across the EEA. This definition is possibly a little less uncertain than that of a UCIS, but still very broad and has only very limited express exemptions;

(c) "retail investment product" ("RIP") for the purposes of the RDR adviser charging and disclosure requirements, a definition which is reasonably clear (apart from the incorporation of the definition of a unit in a collective investment scheme), though still broad by reason of its addition of "any other designated investment which offers exposure to underlying financial assets, in a packaged form which modifies that exposure when compared with a direct holding in the financial asset" and of structured capital at risk products;

(d) "packaged retail investment product" ("PRIP") under EU proposals for harmonised disclosure obligations;

(e) "non complex financial instruments" of the kind which may be sold on an execution only basis under MiFID; and

(f) "non mainstream pooled investments" ("**NMPI**") as defined by CP 12/19.

2 We recognise that there have been some major failures and examples of consumer detriment in the area discussed in CP 12/19 and that the FSA, as precursor to the FCA, is keen to intervene more proactively in the market. It is very much a matter for the FSA to determine policy within the constraints of the statutory provisions. However we think it very important that any product intervention or other rules made by the FSA should be clear and fully thought through.

3 We recommend that before proceeding with either the proposed rules in CP 12/19 or a revised version of those rules the FSA should consider carefully whether it is necessary to create another overlapping definition and:

(a) whether, since the failures cited seem principally to relate to the incompetence (and sometimes dishonesty) of advisers and their failure to follow existing rules on matters such as unsuitable advice, conflicts and fee structures, the new rules are appropriately targeted to achieve the hoped for results, by comparison with, for instance, the implementation of RDR and/or other efforts at improving the standard of regulated firms, including reminders to firms of the kind contained in

CP 12/19 of their responsibilities in relation to appropriateness, suitability and fairness to clients, particularly where less usual investments are concerned;

(b) whether the new rules as drafted are sufficiently clear to address the issue identified in CP 12/19 that a substantial proportion of regulated firms distributing products apparently "did not understand or were not aware of" the rules restricting promotion of UCIS;

(c) whether, rather than depending on the considerable complexity of the interaction of the FSA Rules, the FPO, the PCIS Order and the MiFID and non-MiFID business definitions of a "Professional Client", there may be merit in establishing a separate class of "HNWI"s, with the same or a higher asset or income level than that given in the FPO, to whom NMPIs could be promoted on a fully advised basis on the basis that such people should be able to pay for good advice, rather than being compelled to accept a discretionary management service if they wish to be able to invest in a wider range of assets; and

(d) whether there will be unintended or undesirable consequences in other areas of the market as a consequence of the new rules.

4 Our principal concern with CP 12/19 is the lack of clarity in the new definition of NMPIs. In addition to incorporating the uncertain definition of an unregulated collective investment scheme the NMPI definition also refers to securities issued by a "special purpose vehicle", a term which is even more uncertain in its meaning. The term "special purpose vehicle" is currently used in a number of places in the FSA Rules, frequently undefined in order to encompass its very broad lay meaning. The draft rules presumably intend to adopt the principal definition in the Handbook Glossary which is currently (we believe) only used for mortgage administration and certain regulatory capital purposes:

"a body corporate explicitly established for the purpose of securitising assets whose sole purpose is to carry out one or more of the following functions:

(a) *issuing designated investments other than life policies;*

(b) *redeeming or terminating or repurchasing (whether with a view to reissue or cancellation) an issue (in whole or in part) of designated investments other than life policies*

(c) *entering into transactions or terminating transactions involving designated investments in connection with the issue, redemption, termination or re-purchase of designated investments, other than life policies"*

5 The draft rules then exclude from that definition of a special purpose vehicle:

(i) *an investment trust;*

(ii) *a covered bond;*

(iii) *a security whereby the issuer's payment obligations to the investor are linked to, contingent on, highly sensitive to or dependent on the performance of or changes in the value of shares or bonds admitted to or dealt on a regulated market or on a market that is recognised as a market or exchange by an overseas regulator, whether or not such performance or changes in value are measured with reference to specific shares or bonds or via a market index or indices.*

6 It is not clear to us that an investment trust would, but for its express exclusion, have been caught by the definition of a special purpose vehicle, since it is not clear to us that an investment trust can be regarded as having been "explicitly established for the purpose of securitising assets", nor as having as its sole purpose the issue and redemption of securities. On the contrary, that description would seem to fit accurately securitisation vehicles and a number of other structures established to hold specific assets but not necessarily to be a good description of most investment trusts or indeed other investment companies which are established to carry out active management of assets on an ongoing basis in accordance with a defined investment policy. Though there may be a degree of overlap they seem to us to fit better into the definition of an AIF (which in turn excludes securitisation vehicles). The express exclusion of investment trusts therefore generates more uncertainty over the meaning of "special purpose vehicle" incorporated within the term "non mainstream pooled assets". Consideration should be given to whether this uncertainty creates any difficulties in other situations where the defined term "special purpose vehicle" is used, notably in relation to regulatory capital.

7 Although the principal policy concern expressed in CP12/19 and summarised in the "Glossary" definition at the front of the CP relates to "pooled investments ... characterised by unusual, speculative, or complex assets, product structures, investment strategies and/or terms and features" the proposed definition of the terms does not require those features to be present. There does not seem to be any requirement in the definition for "pooling", since a traded life policy investment might be a single such policy. Although a number of examples are given, it is not entirely clear what is meant by "unusual, speculative or complex assets," nor does there seem to be a clear requirement that the investment concerned should in fact be "non mainstream". The result of the definition appears to be that this term means any asset other than regulated collective investment schemes, endowment assurance policies and shares or bonds listed or dealt on a regulated market or overseas equivalent (though the scope of listed companies that would fall within scope is also not clear). We note that:

(a) a UCIS might invest in "mainstream" assets in a fully diversified and locally or internally regulated manner. Indeed even a scheme which is authorised in its home country under the UCITS Directive counts as a UCIS for UK regulatory purposes unless and until it gives notice to exercise its cross border passport.

(b) an ordinary company issuing a single class of shares is probably the simplest product structure in existence.

(c) shares or bonds listed or dealt on a regulated market are, regrettably, not always liquid and may relate to a company which is highly risky, speculative or unusual in nature. The definition of an SPV may exclude some of these companies but does not exclude a product linked to them.

(d) it is not clear whether or not the definition is intended to capture structured notes issued by banks.

In essence, if the FSA's primary concern relates to a particular product type, then the regulatory response ought to be aimed more specifically at that. If instead it relates more to a particular competence, the regulatory response might better be aimed at that (e.g. restricting advice on UCIS products unless the adviser holds a suitable qualification).

8 We are particularly concerned that the complexity and uncertainty of the new draft definition and rules may increase the risk that the restrictions will be as "widely misinterpreted, poorly understood and sometimes simply ignored" as are the current UCIS restrictions, according to paragraph 1.9 of the CP.

9 Indeed there are a number of points where CP 12/19 could itself be misunderstood to mean that the new restrictions will only apply to "ordinary" or "average" retail clients and will not apply to high net worth or sophisticated clients. That this is not in fact the case is only indicated in passing by the brief statements in the sections on self certified sophisticated investors and certified high net worth investors that “not all non-mainstream pooled investments may be promoted under these exemptions”. There is no attempt to explain more fully that those exemptions are available only for shares and debt securities in certain unlisted companies (using an unusual definition of an unlisted company) and certain, but not all, other investments related to such shares and debt securities. Nor is there any indication that the exemption for promotions to sophisticated investors requires the certification to be given by a firm which is not (under PCIS) the operator of the scheme or vendor of the units nor (under FPO) any person with whom the investor is being invited or induced to engage in any investment activity.

10 More helpfully, the draft rules relating to the "one off" exemption do cross refer to the relevant guidance in PERG 8.14.3-13. However, at paragraph 3.42, the consultation paper does not seem to us fully to reflect that guidance. While we agree that material which is simply part of an organised marketing campaign regularly promoting an NMPI is unlikely to meet the requirements of the exemption, a personal recommendation which is tailored to the requirements of the individual investor (which is the essence of a personal recommendation) and addressed to that investor would normally meet the requirements. The guidance in PERG makes a clear distinction between, on the one hand, general mailshots and, on the other hand, advice in which the individual circumstances

and objectives of each client are considered before determining that the opportunity would be suitable for that client. Although tailored investment advice may include a financial promotion it will be an exempt/excluded communication if either solicited or unsolicited but given to a client who is reasonably considered to understand the risks and to be expecting such communications.

11 The proposed rules appear to us to generate a number of consequences which are not necessarily intended or desirable, including that:

(a) it will be easier to promote a UCIS or QIS investing in the shares or debt securities of a company which is not listed and has made no attempt to introduce any liquidity to self-certified sophisticated investors or certified high-net worth individuals, than a UCIS or QIS investing in highly liquid listed instruments;

(b) depending on the interpretation of the term "special purpose vehicle", it may be easier to promote a UCIS or QIS specialising in venture capital than a listed Venture Capital Trust;

(c) depending on the interpretation of the term "special purpose vehicle", an SPV related to shares in a listed investment company would not be an NMPI but the listed investment company itself might be. Structured notes issued by a bank would not appear to be NMPI;

(d) depending on the interpretation of the term "special purpose vehicle", conversions of real property companies into REITs may be made more difficult;

(e) some companies will be able to issue prospectuses but not related explanatory material which might be regarded as promotional in nature;

(f) it will be easier to promote derivatives relating to UCIS/QIS/SPVs or endowment assurance policies wrapping them than to promote the UCIS/QIS/SPV itself;

(g) some corporate finance transactions and restructurings could be affected; and

(h) it is not clear how some new products such as social investment bonds will be treated.

12 We should be interested to know the basis on which the FSA considers it appropriate to apply these provisions to EEA firms exercising crossborder services passports under European Directives, and how it may affect the approach taken by other Member States to those passports, since the reversal of the position previously adopted by the FSA is presumably a general change to its interpretation of the Single Market Directives. There does not appear to be any explanation or argument in the CP relating to this change.

13 We set out below brief answers to certain of the specific questions raised in CP 12/19. However our general comments above apply to almost all of the questions

Q1 *Do you agree that we should look to impose restrictions on the promotion of non-mainstream pooled investments to ordinary retail investors*?

This is a policy decision for the FSA. We believe that in order to answer the question properly it is necessary to be clear as to what is meant both by "non-mainstream pooled investments" and what is meant by "ordinary retail investors". CP12/19 is not sufficiently clear on either term.

There may be some investors who either by reason of their wealth, or by reason of their knowledge of a particular underlying asset class, should not be regarded as "ordinary" for the purposes of some pooled investments.

Q2: *Are there any other investments that should be treated in the same way?*

This is a policy decision for the FSA. We consider that whatever policy decision it reaches should be clearly articulated in the rules.

Q3: *Are there any investments caught by the non-mainstream pooled investment definition in the draft rules that you believe should not be?*

It is not clear to us that VCTs and other listed investment companies, other than investment trusts, either are or should be caught by the definition.

Q4: *Do you agree that we should remove the general ability of firms to promote UCIS under COBS 4.12.1R(4) category 1?*

This is a policy decision for the FSA.

Q5: *Do you agree that firms should still be able to promote replacement UCIS to retail customers where the original product is being replaced or liquidated?*

We agree with the FSA that inability to promote replacement UCIS in these circumstances would risk failure to give the retail clients adequate information on their options.

Q6: *Do you agree that we should remove the ability of firms to promote UCIS under COBS 4.12.1R(4) category 2?*

Category 2 is complex in its formulation and difficult for firms to follow. That does not however mean that it should be removed , clarification would be better.

Q7: *Do you agree that we should remove the exemption in COBS 4.12.1R(4) category 8?*

Although it is a policy decision for the FSA we think it would be more appropriate for the FSA to institute and apply strictly a requirement for firms to undertake proper assessment of expertise, and/or high net worth with related warnings both as part of the process and when undertaking a promotion based on that assessment, than to fall back on the FPO and PCIS Order provisions and the definition of Professional Client. We note that the MiFID definition of a Professional Client is ill-adapted for those who seek to invest for the long term and avoid churning their portfolios and the non-MiFID definition is very similar to category 8, and also that "opting up" would remove other protections from the expert retail client who wishes to invest in NMPIs.

The FPO and PCIS Order provisions are logically the minimum freedom which can be given to authorised firms to promote NMPIs, unless all such promotion is to be undertaken from outside the UK by unauthorised firms, thus reducing rather than improving, consumer protection. However the statutory provisions are complex and regulated firms are accustomed to referring to the FSA Rules for the provisions applicable to them so it might be better to set out a uniform process and standard within the FSA Rules for all NMPIs, once that category of investment is properly defined.

Q8: *Do you agree that we should limit the ability of firms to promote QIS, securities issued by SPVs and TLPIs in the retail market?*

This is a policy decision for the FSA but the definition of an SPV needs to be improved before there should be any limitation relating to them.

Q9: *Do you have any comments or suggested improvements for our approach to SPV-issued securities, including structured products?*

For the reasons given above we consider that the definition of SPV issued securities requires a fundamental rethink. It is not clear to us why such a different approach is being taken to SPVs (however defined) than to derivatives, structured products and life policies.

Q10 *Do you have any comments on the Handbook guidance we propose to add regarding the use of exemptions in the FPO and PCIS Order?*

For the most part the guidance does not assist comprehension of the exemptions.

Q11 *Do you agree that we should require firms to retain a record of the basis on which the promotion of a non-mainstream pooled investment has taken place for each financial promotion?*

We think it is best practice to do so, except that where tailored individual advice is being given it would not be normal and should not be necessary to include a separate record of that fact that it is "one off" in nature.

Q12: *Should we require confirmation of compliance with the marketing restriction for each promotion?*

Generally we think that is best practice, with the same qualification concerning tailored individual advice.

Q13: *Do you agree that the CF10 individual is the correct person to confirm compliance?*

It depends on the firm concerned and the size and nature of its compliance department.

Q14: *Do you have any comments on the Handbook guidance we propose to add regarding the link between promotion and advice?*

See our general comments above. The guidance in relation to suitability is misleading unless appropriate reference is made to the one off exemption.

Q15: *Do you agree with our proposed update to the retail investment product definition?*

Our only comment is the general need to clarify the definition of an NMPI.

Q16: *Do you have any comments on the impact of our proposals on existing customers and the distributor firms serving them?*

Our principle concern is lack of clarity. Secondary concerns include (a) the possible reduction in good quality advice to high net worth investors and those who are expert in a particular asset class (b) possible impact in other fields such as corporate finance (c) possible migration of bad practice to even less regulated areas or more risky products.

Q17: *Do you have any comments on our analysis of non-mainstream pooled investments?*

Please see our comments above.

Q18: *Do you have any further data on the size of the market?*

Not generally but we do question the data referred to. Footnote 23 says that there were over 500 structured products launched with the legal form of SPV issued securities in 2011 of which only 27 would fall within the NMPI definition (because linked to assets other than listed securities/indices). However one member of the Committee commented that his firm had advised on around 30 such products in a similar period so those figures seem to be a potentially significant underestimate.

Q19: *Do you have any comments on our overall strategy to deal with the risks to retail customers of investing in UCIS?*
We are not sure if this question was intended to refer to NMPI. If so then we refer to our comments above. More generally we note that although the strategy addresses some

risks of dubious practices migrating into "near substitutes," it treats some long established retail products in the same way as products which are genuinely unusual, speculative or complex and, on the other hand, does not address some other risky related products.

The Committee would very much like to discuss, with the FSA, the responses and observations outlined in this letter. Accordingly, we would like to arrange a meeting with you. If you would be amenable to attending such a meeting, please contact Margaret Chamberlain of Travers Smith either by telephone on +44 (0) 20 7295 3000 or by email (margaret.chamberlain@traverssmith.com).

Yours sincerely

Margaret Chamberlain

Chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

Margaret Chamberlain (Travers Smith LLP) (Chair)
Karen Anderson (Herbert Smith LLP)
Chris Bates (Clifford Chance LLP)
David Berman (Macfarlanes LLP)
Peter Bevan (Linklaters LLP)
John Crosthwait (Independent)
Richard Everett (Lawrence Graham LLP)
Robert Finney (Holman Fenwick Willan LLP)
Angela Hayes (Mayer Brown International LLP)
Jonathan Herbst (Norton Rose LLP)
Mark Kalderon (Freshfields Bruckhaus Deringer LLP)
Ben Kingsley (Slaughter and May)
Nicholas Kynoch (Berwin Leighton Paisner LLP)
Tamasin Little (S J Berwin LLP)
Simon Morris (CMS Cameron McKenna LLP)
Rob Moulton (Ashurst LLP)
Bob Penn (Allen & Overy LLP)
James Perry (Ashurst LLP)
Stuart Willey (White & Case LLP)