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Insurance Law Committee response to HM Treasury's consultation on draft regulations implementing a framework for insurance linked securities

The City of London Law Society ("**CLLS**") represents approximately 15,000 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 response in respect of HM Treasury's consultation on draft regulations implementing a framework for insurance linked securities has been prepared by the CLLS Insurance Law Committee (the "**Committee**").

HM Treasury has published a consultation on regulations to implement the insurance linked securities regime on which it consulted in early 2016. The Committee's responses to HM Treasury's questions in its most recent consultation are set out below, together with some additional comments on the draft regulations. Our comments relate to the draft Risk Transformation Regulations 2017 (the "**Risk Transformation Regulations**") and the Risk Transformation (Tax) Regulations 2017 (the "**Tax Regulations**").

1. DIRECTORS AND DIRECTORS' DUTIES

The Committee's comments on these provisions will be sent to the PRA and the FCA in response to their joint consultation, as the comments relate to the subject matter of that joint consultation.

2. REPORTING AND ACCOUNTS

The Committee has no comments on these provisions.

3. AUDIT REQUIREMENTS

The Committee has no comments on the proposed audit requirements or on whether a reduced disclosure regime might be appropriate.

4. INSOLVENCY

There are three potential insolvency scenarios, namely (i) the insolvency of one (or more) cells, (ii) the insolvency of the core and (iii) the insolvency of both the core and one or more cells. We believe that the issues arising where a cell goes into liquidation or administration, but the core remains solvent and continues to operate, are relatively easy to address, and are largely dealt with in the Risk Transformation Regulations.

The position where the core goes into liquidation or administration may, however, require further consideration, as it will be important to ensure that the stakeholders in each cell can be satisfied that the administration or liquidation of the core will not have an adverse impact on the ongoing viability of that cell.

We believe that there are two specific measures which may assist in providing such stakeholders with the comfort that they will be looking for.

i. The first would be to provide in the Risk Transformation Regulations that any administrator or liquidator of the core would be required to continue providing services to each cell, on the same basis that they were provided prior to the core going into administration or liquidation.

   This amendment would mean that the stakeholders in the cell could be reassured that any administrator or liquidator of the core would, provided that the cell continued to comply with its payment obligations, continue to provide services as before, unless and until the cell in question is dissolved, transferred or finally wound-up.

   We are making this proposal as concerns may arise where sub-paragraph 2(4) of Schedule 3 to the Risk Transformation Regulations is disapplied in circumstances where the administrator of the core is aiming to rescue the core as a going concern. We assume that the legislative expectation is that, in such circumstances, the administrator of the core would be seeking to maintain the existing relationship between the core and the cell(s), but stakeholders could be concerned that the administrator might technically be permitted to try to impose new charging structures on the cell(s), in order to improve the prospects of rescuing the core as a going concern, and that this would unfairly prejudice the stakeholders in the cell(s).

ii. The second measure, looking at essential supplies provided by third parties, would be to make it clear that the provisions contained in Section 233A of the

Insolvency Act 1986 (the "**IA**"), which are intended to ensure the continuation of essential supplies to a company in administration, should also apply to cells. This would mean that a contract entered into on behalf of a cell should not be terminable because either (i) the cell goes into administration or (ii) the core or another cell goes into administration.

Our concern is that Section 233A was drafted assuming that the company had entered into a contract. It did not contemplate the current situation, where contracts would, under Regulation 55, be entered into on behalf of, rather than by, that cell. We do not believe that a cell should be deprived of the statutory protection provided to other entities which go into administration simply because of the specific contractual mechanics inherent in the protected cell structure.

There is clearly some overlap between these two proposals, but the key difference is that the requirement that the core should continue providing services would apply whether or not the cell was in administration, while the minor technical modification to Section 233A would only apply where the cell was in administration.

While these are the most significant insolvency related issues, we have identified a number of more technical insolvency points which might helpfully be addressed, in order to both increase clarity and speed up the process. These are set out in the Schedule to this response.

5. THE COMMITTEE'S ADDITIONAL COMMENTS

(a) Classification of an ISPV

The consultation papers refer to an ISPV's debt issuance "*or other funding mechanism*". If it is contemplated that ISPVs can raise funding from investors otherwise than by issuing debt, then consideration will need to be given to whether (i) such arrangements could constitute a collective investment scheme (a "**CIS**") (for the purpose of Section 235 of the Financial Services and Markets Act 2000) and (ii) the ISPV could be characterised as an alternative investment fund (an "**AIF**") under Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (the "**AIFMD**"). In either case, this would have a regulatory consequence for how the ISPV would need to be operated and marketed.

Most repackaging transactions seek to embed a debt to ensure that they do not fall to be characterised as a CIS or AIF – this is intended to avail themselves of exemptions that are available. Rights or interests of investors in instruments creating or acknowledging indebtedness of the kind specified in Article 77 or 77A of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "**RAO**") are exempted from being a CIS (subject to some additional requirements). There is also

PERG guidance indicating that, in general, an issue of debt securities will not be an AIF.

Although not clear-cut in its application to all SPV-issued securities, the FCA has stated that until they receive further clarification from ESMA, they will assume that debt securities which fall within the CIS 'debt exemption' are not AIFs.

Accordingly, if the ISPVs are potentially issuing something other than debt, there will need to be some other route to exempt them from being a CIS or AIF (assuming this is HM Treasury's intention).

(b) Regulated activities

It is unclear what could fall within the definition of a "*non-Solvency 2 transformer vehicle*". A "*special purpose vehicle*" is defined in Solvency II as an entity which funds its exposure through the proceeds of a debt issue etc "*where the repayment rights of the providers of such debt or financing mechanism are subordinated to the reinsurance obligations of*" such entity. This suggests that if the risk is assumed under an arrangement which is not a reinsurance obligation it is not a "*special purpose vehicle*" but it could still be a transformer vehicle (and accordingly a "*non-Solvency 2 transformer vehicle*"). Is this HM Treasury's understanding of what a "*non-Solvency 2 transformer vehicle*" is?

The Committee also considers that the definition of "*insurance risk transformation*", as contained in regulation 4(3) of the Risk Transformation Regulations, could be tightened.

(c) Taxation

Regulation 4(2)(b): Excess Investments

The effect of regulation 4(2)(b) of the Tax Regulations (coupled with paragraph (3) of regulation 4 of the Tax Regulations) is to withdraw the corporation tax ("**CT**") exemption granted by paragraph (1) of regulation 4 of the Tax Regulations if and to the extent that a qualifying transformer vehicle holds more investments than it needs to satisfy the "fully funded requirement" imposed on the vehicle by relevant regulatory law. That means, presumably, that any profits or gains deriving from the ownership or disposal of such excess investments should be exposed to CT in the normal manner.

We propose that some tolerance or margin should be included in this restriction on the exemption (in addition to the 30-day rule in paragraph (3) of regulation 4 of the Tax Regulations) as it may otherwise be difficult for the ISPV to tread the line between ensuring that it is fully-funded but that it does not have any excess investments. This could be achieved, for example, by extending the basic tax exemption to investments which, although technically exceeding the minimum level of investments required to satisfy the fully-funded requirement, had nonetheless been obtained solely in order to safeguard continuing compliance with the fully-funding requirement and whose aggregate value did not exceed, by more than a specified percentage, the aggregate value of the investments needed to satisfy the requirement.

<u>Compliance/Anti-avoidance Infringements: regulation 6 regime</u>

Collective approach to sanctions

Although an ISPV would be a single legal entity, commercially the cells would operate on an individual basis and it would therefore be preferable and more in line with the commercial reality to apply the sanctions regime in regulation 6 of the Tax Regulations to each cell as if that cell were a separate company.

Impact of a single failure

We note that under the Tax Regulations a single failure to satisfy a single one of the three Conditions prescribed by regulation 6 of the Tax Regulations causes the ISPV in question to forfeit the tax exemption granted by regulation 4(1) of the Tax Regulations both for the accounting period in question and for all future accounting periods. We propose that a more proportionate regime should apply under which only a breach of Condition C in the Tax Regulations would be viewed as a major breach leading to automatic forfeiture of the tax exemption. Occasional/ remedied breaches of Condition A should not automatically lead to a loss of the tax exemption but might cumulatively do so. We do not think that breach of Condition B should lead to forfeiture of the tax exemption – discussed below.

Condition A

Condition A states that a qualifying transformer vehicle will forfeit its tax benefits if a particular investor in the ISPV both holds more than 20% of the "*insurance risk transformation investments*" and is "*connected*" for tax purposes with the insurance company (or other entity) which was the cedant of the risk assumed by the vehicle.

It is not entirely clear what constitutes "*insurance risk transformation investments*" for these purposes – i.e. do they include shares issued by the core and do they include both non-voting shares and debt securities issued by the cells? It is also not clear whether the 20% limit applies on a cell-by-cell basis. The Committee considers that if the shareholders of a cell which assumes risks from an undertaking are not connected to that undertaking and the shareholders are passive (e.g. have no voting rights in respect of the cell, as the Tax Regulations provide), regulations 4 and 5 of the Tax Regulations should not be disapplied. Accordingly, the Committee recommends (A) clarifying whether the 20% threshold in regulation 6(2) of the Tax Regulations applies to shares held in the core, the cells, or both, and (B) considering the circumstances in which regulations 4 and 5 of the Tax Regulations should be disapplied. If the 20% threshold is to apply to the cells as well as the core, and if the sanctions regime is changed to apply on a cell-by-cell basis, it may be more appropriate for the 20% threshold also to apply on a cell-by-cell basis.

Furthermore, the absolute nature of the 20% limit may be problematic on start up where there are only a small number of investors if any of these are connected with the cedant. We think that a more flexible approach would be more practical, for example in line with the investment manager's exemption which would look at the average percentage interest in the PCC over an initial period.

Condition B

Under Condition B, a qualifying transformer vehicle potentially loses its tax-favoured status solely by virtue of conduct which has resulted in one of the three compliance penalties specified in that Condition. Arguably these should not lead to a loss of tax status at all, rather the penalties themselves should be sufficient. It is inconsistent with the tax regime more generally to apply both a penalty and then a sanction for having incurred the penalty.

Condition C

The phrase "*tax advantage*" within the Condition needs to be defined: either within the Tax Regulations themselves or, alternatively, by cross-reference to one of the definitions of that phrase elsewhere in UK tax legislation. In addition, the reference in Condition C to "*one of the main purposes*" being a tax advantage is potentially quite broad.

<u>Losses and Group Relief: regulations 7 & 8 of the Tax Regulations</u>

Regulation 7 of the Tax Regulations, as currently drafted, raises two unanswered questions:

i. What will be the tax status of any losses accruing to an ISPV which is a qualifying transformer vehicle? Are those losses to be disallowed for tax purposes, so as to secure symmetry with the tax exemption granted to the profits of such a vehicle by regulation 4(1) of the Tax Regulations? Or will, by contrast, any losses incurred by a qualifying transformer vehicle be treated no differently from any other losses incurred by a company, for the purposes of potential offset against taxable profits realised elsewhere in accordance with the usual rules of UK tax law regarding the usability of tax losses?

ii. What is to be the status of an ISPV for group relief purposes? Regulation 8 of the Tax Regulations makes it clear that a qualifying transformer vehicle cannot be treated as part of anyone else's tax group or consortium; however, will an ISPV <u>in itself</u> be regarded as a group for group relief purposes, so that losses incurred by the notional company represented by one cell can potentially be set off against taxable profits realised by the notional company represented by another cell? The Committee considers that it may be possible to argue in favour of either result from a policy perspective but it would be helpful if the Tax Regulations were clear on the point.

VAT

Any supply of investment management or investment advisory services to a transformer vehicle would, typically, be a supply which attracts VAT at the standard rate. Since all, or almost all, the activities of a typical transformer vehicle will constitute the making of exempt supplies for VAT purposes, none, or almost none, of that VAT will be recoverable by the transformer vehicle. As such, the VAT borne on the investment manager/adviser's supply will represent an outright additional cost for the vehicle. We question whether this is the right result, as it will have a detrimental effect on the competitiveness of the vehicle.

(d) Transfers of business

The Committee considers that HM Treasury should clarify whether the insurance business transfer regime in Part VII of the Financial Services and Markets Act 2000 would apply to an ISPV, i.e. whether all or part of the business of a cell could be transferred by way of a Part VII transfer.

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SCHEDULE

(i) **Schemes of Arrangement:** Regulation 163(1)(a) provides that a protected cell company may not propose a voluntary arrangement (a form of statutory cram-down procedure). Permitting a cell or the core to be wound up as an unregistered company may, however, open up the technical possibility of such entities proposing a scheme of arrangement (another statutory cram-down procedure) instead.

This is because, under section 895(2)(b) of the 2006 Companies Act, a scheme can be sanctioned in respect of "*any company liable to be wound up under the Insolvency Act 1986*". This test includes companies which may be wound up under Section 221 IA as "*unregistered companies*". If the policy objective is to prevent protected cell companies from using statutory cram-down procedures, it would appear that Regulation 163(1) should be extended, so as to include Schemes of Arrangement.

(ii) **Contributories:** The consultation contemplates a cell being wound up as an unregistered company under Part V of the IA, but does not disapply Section 226 IA (Contributories in winding up of an unregistered company). We assume that the scope for contributories incurring liability was intended to be limited to the circumstances set out in Section 76 IA, as modified in Schedules 2 and 3 of the Risk Transformation Regulations, and that the continued application of Section 226 IA may be an oversight.

We note in this context that the Open-Ended Investment Companies (Amendment) Regulations 2011 which, from an insolvency perspective, permit a sub-fund to be wound up as if it were an unregistered company, did disapply Section 226.

(iii) **Floating chargeholders:** The following two points arise in relation to Paragraph 4 of Schedule 2 and Paragraph 6 of Schedule 3 of the Risk Transformation Regulations:

(a) It appears from Paragraphs 4(1) and 6(1) that the holder of a floating charge cannot apply to court for the appointment of an administrator, but that, as Paragraph 12 of Schedule B1 to the IA is not disapplied, any other creditor can do so. It is unclear why this restriction has been imposed.

(b) These provisions disapply the requirement to obtain the consent of any floating chargeholder before appointing an administrator, but do not disapply the requirement to give prior notice to such chargeholder. It may be advisable to do so in order to avoid a five day hiatus, given the notice requirements contained in Paragraph 26 to Schedule B1 to the IA, which have not been disapplied.

(iv) **Directors' powers**: Paragraph 3 of Schedule 3 to the Risk Transformation Regulations provides that where the core of a protected cell company goes into administration or liquidation, the directors of the company may not exercise any "*management power*" which could interfere with the exercise of the administrator or liquidator's duties. It is unclear why there is not an equivalent provision where a cell goes into administration or liquidation, as considerable uncertainty could arise if the directors of the protected cell company could potentially interfere with the management of that cell, frustrating the strategy of its administrator or liquidator.

(v) **Notification of insolvency**: Two points may be worth considering:

(a) If it is necessary, in Table 6 of Schedule 3, to modify Paragraph 45 of Schedule B1, which applies on administration, it would seem logical to make similar modifications to Section 188 IA (the equivalent provision applicable on liquidation); and

(b) Paragraph 5 of Schedule 2 disapplies the requirement to give notice of a protected cell's insolvency on the company's website, but it does not appear to disapply the requirement to give such notice in any order or letter issued by the company (as required by Para 45 of Schedule B1 and Section 188 IA). It therefore appears that a protected cell company might, on a cautious reading, be required to refer to the insolvency of cell A in any business document issued on behalf of cell B.

(vi) **Administrators' powers:** Table 6 to Schedule 3 appears to give the administrator of the core the ability to pursue a misfeasance action against an administrator of any cell, but the latter does not appear to have the power to bring a misfeasance action against the administrator of the core (which may be a more likely scenario).

(vii) **Preferential creditors**: Paragraph 2 of Schedule 2 to the Risk Transformation Regulations treats an employee of the protected cell company as an employee of the cell for the purposes of insolvency legislation. This could give rise to an argument that an employee of the core could look to any cell for at least the preferential element of its claim if this was not paid in the liquidation of the core. It might be helpful to make it clear whether this is the intention and, if not, how such preferential claims should be treated.

THE CITY OF LONDON LAW SOCIETY
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