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By email: NTDS-Consultation@hmtreasury.gov.uk

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Dear Sir or Madam

HM Treasury consultation on the regulation of non-transferable debt securities

The City of London Law Society ("**CLLS**") represents approximately 17,000 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.

The Committee welcomes the opportunity to respond to the HM Treasury Consultation Document ("**ConDoc**") on non-transferable debt securities ("**NTDS**"). Although this response is not structured so as to follow the questions in the ConDoc, the Committee's comments have taken account of the areas of focus disclosed by those questions.

In general terms the Committee has concerns about the piecemeal approach to reform relating to the selling of financial products (i.e. this consultation and those relating to financial promotions, crypto-assets and others). In particular, in this context, the Committee is concerned that the approach adopted in the ConDoc suggests a "knee-jerk" response to public and political outcry about a particular scandal rather than a strategic and thoughtful review on an issue of more general application, identified as being in need of reform. There is a considerable risk in such circumstances that any speedy change creates significant unintended consequences to the detriment of the UK's financial services sector. A piecemeal approach to reforms adds to that risk. The approach in the ConDoc is all the more surprising given ongoing wider-ranging reviews covering the same kinds of issue – in particular we note the "Wholesale Markets Review" consideration of the appropriate balance between consumer protection and retail investment (see paragraphs 9.8-9.11 of that Review document).

The Committee does not underestimate the impact of the London Capital & Finance ("**LCF**") failure on those who invested, nor does the Committee disagree with the published findings of the various

enquiries into that failure that the UK regulators might legitimately have done more to avoid its occurrence. The Committee agrees that the way in which LCF operated bore some resemblance to activities subject to regulation (notably fund management or deposit taking).

However, the Committee notes that the ConDoc itself acknowledges that the market in NTDS has been declining in favour of transferable debt securities which are already within the regulatory regime (and eligible to be held within an ISA, unlike NTDS). The Committee considers, in the light of that, and the increased awareness about the risks arising from NTDS, the case for extending and potentially adding complexity to the regulatory perimeter is not made out (i.e. Option 3 is in our view to be preferred). As the Consultation Document notes, there are existing powers available to the FCA, and other proposals put forward by HM Treasury relating to financial promotions, that are capable of addressing the issues that arose in LCF. The Consultation Document appears to rely on perceived deficiencies in existing powers alone, without identifying any particular benefits in its preferred solution (Option 1). As a minimum, HM Treasury should allow changes elsewhere to take effect, before assessing their impact, and considering the value of further changes.

Although the Committee has not been persuaded by the Consultation Document that further changes to the regulatory regime are necessary, it has considered the other options put forward. As the Consultation Document notes in relation to Option 2, prospectuses are typically lengthy and contain a large amount of detailed information (much of which is prescribed), and the "approval" by the FCA of a prospectus raises the risk of being misconstrued by retail investors. This risk of the FCA's involvement being misconstrued appears to have been a central factor in the way that LCF operated. As such, we agree with the conclusion in the Consultation Document that Option 2 would not materially improve the position for retail investors.

The Committee considers that if HM Treasury decides to make some change to the regulatory regime, its preferred option of amending the Regulated Activities Order ("**RAO**") (Option 1) is preferable to revising the scope of the Markets in Financial Instruments Directive ("**MiFID**"). The MiFID scope was implemented by the UK through the RAO, and any change to that scope would necessitate changes to the RAO in any event. The Committee considers that if there is to be any change to the RAO, this should be done directly, and with care to ensure that it does not impact more widely than the harm the change seeks to address. The Committee considers that amending article 18 RAO to do this would be an appropriate mechanism, but that any amendments would need to be done with great care.

The Consultation Document (and the Gloster Report) focus on the issue of NTDS to individuals by LCF, where LCF used the proceeds to lend to others for reward. Any change to the RAO should be carefully constructed to address that issue without unintended adverse consequences in other contexts. The Consultation Document recognises one instance of this risk – that of "real economy" issuers raising their own debt capital. However, it is unclear whether this is, for example, intended to include the raising of finance for group businesses by a parent or group SPV entity.

The use of non-transferable debt instruments in other contexts, such as in the issue of instruments as a form of employee remuneration (whether to meet regulatory requirements or otherwise) would fall outside the kind of mischief highlighted by the ConDoc as arising in the LCF case. Additionally, certain securitisation models may involve an SPV being set up by a financial institution, and the SPV issuing non-transferable debt instruments to finance the acquisition of credit portfolios (e.g. on a basis akin to a protected cell company). In that scenario the appropriate candidate for authorisation is the financial institution and not the SPV.

One approach would be to disapply the exclusion in RAO art 18 to the issue of debentures where particular conditions are met, e.g.:

- The debentures are promoted to individuals otherwise than in the course of their occupation or employment (such as investment professionals, who should have the experience/nous to assess such an offer; but could include employees of the issuer/group); and

- The proceeds of the issue are, or are reasonably expected to be, used by the issuer to fund the making of loans to unconnected parties; and

- Where instruments are being issued to individuals other than employees of the issuer, or an affiliate of the issuer, the denomination per unit of the debentures being issued is less than £100,000. (i.e. the exclusion still applies if the unit denomination is £100k or more)

  We note that this approach is in line with the FCA's approach on restricting the making of financial promotions about this kind of instruments, for example at COBS 4.14.20 for speculative illiquid securities (into which category we understand NTDS to fall).

Because of the potential for unintended consequences of cutting back RAO article 18, the Committee urges HM Treasury to consult on the precise wording to be adopted, if it decides to pursue this option.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at Karen.Anderson@hsf.com in the first instance.

Yours faithfully

Karen Anderson
Chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

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