International
Capital
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Association

ICMA

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(Submitted via email to cp14-23@fca.org.uk)

27 January 2015

Dear Mr Pope and Ms Dormido Jordá,

Consultation Paper – Restrictions on the retail distribution of regulatory capital instruments (CP14/23)

The International Capital Market Association (ICMA) is responding to the above.

Setting standards internationally, ICMA is a unique organisation and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years. See: www.icmagroup.org.

ICMA is responding in relation to its primary market constituency that lead-manages syndicated debt securities issues throughout Europe. This constituency deliberates principally through ICMA's Primary Market Practices Committee[1], which gathers the heads and senior members of the syndicate desks of 48 ICMA member banks, and ICMA's Legal and Documentation Committee[2], which gathers the heads and senior members of the legal transaction management teams of 18 ICMA member banks, in each case active in lead-managing syndicated debt securities issues in Europe.

We set out our response in the Annexes to this letter and would be pleased to discuss it with you at your convenience.

Yours sincerely,

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[1] http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/Primary-Market-Practices-Sub-committee/.
[2] http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/Legal-and-Documentation-Sub-committee/.

ANNEX 1

A. GENERAL REMARKS

1. We welcome the opportunity to engage with the FCA in relation to the proposed restrictions on the retail distribution of regulatory capital instruments. This response focuses on the CoCo and Co-Co fund aspects of the FCA's consultation paper (**CP**), and not on aspects relating to mutual society shares.

2. The FCA is not the only regulator focusing on the retail distribution of regulatory capital instruments. ESMA, German BaFin, Danish FSA, Italian Consob and Hong Kong SFC (and possibly others) have also issued guidance and statements on this topic. If other regulators were to impose product intervention rules in the way the FCA has done, then market participants could face conflicting or inconsistent rules in different jurisdictions, which would be very unhelpful in cross-border offerings of affected securities. On the other hand, outside the UK where other regulators have not imposed restrictions on the distribution of CoCos, FCA firms will presumably need to seek to impose the FCA's rules on non-UK financial intermediaries, which could be problematic. The FCA's proposals could also impact upon the costs to non-UK banks of issuing CoCos. We discuss these points further in paragraphs 21 and 54, respectively.

3. One of the most concerning aspects of the CP is the FCA's approach appearing to have two layers. First, there is the actual restriction in COBS 22.2 and the various exemptions. Secondly, there appear to be statements relating to suitability of CoCos for retail investors (in COBS 22.2.4G and paragraphs 2.18 and 2.39 of the CP), appearing to state that CoCos are only suitable for a specific sub-set of investors within the sophisticated investor exemptions. This second aspect should relate to financial intermediaries' suitability assessments under MiFID, rather than the restriction itself. However, the CP appears to layer the second aspect on top of the restriction and the exemptions, which could be interpreted as narrowing the availability of the exemptions in COBS 22.2.2R. This could have a significant impact on the CoCo market. We discuss this further in our response to Q7 below.

4. Another particularly important point is how the proposals apply to promotions of CoCos to discretionary investment managers. Given the FCA's proposals are based on the premise that a CoCo cannot be properly understood by a mass retail investor, there is no policy reason for restricting the promotion of CoCos to a discretionary investment manager who manages a portfolio on behalf of a retail client and takes all decisions in relation to it in accordance with MiFID. We discuss this further in paragraph 13 below.

5. Two other important aspects of this response are the need to ensure clarity in (i) the scope of products to which COBS 22.2 applies (see paragraph 8 below); and (ii) how the rules apply to promotions of CoCos to non-UK financial intermediaries (see paragraphs 21 – 25 below).

B. FCA QUESTIONS ON COCO PMR

Q1: Do you agree with our proposals to restrict the retail distribution of CoCos?

6. ***General*** – We agree that CoCos are complex instruments and have a risk profile that mass retail investors might find difficult to understand, which has been stated or alluded to by various regulators both in Europe and beyond. As such, we can understand why it is felt that firms should not promote or sell such products to ordinary retail investors. One of the ways this can be achieved is through product intervention rules such as the FCA's temporary product intervention rules currently in place (**TMR**) and the proposed permanent restriction (**PMR**). However, other approaches such as enforcing MiFID against financial intermediaries who mis-sell products and/or issuing guidance statements (which is the approach

taken by various other regulators) might have had a similar result without the cost implications of the TMR and PMR.

7. However, assuming the FCA will retain a product intervention approach, there are some points of detail in the drafting of the proposed provisions that are problematic.

8. ***Product scope - Definition of "contingent convertible instrument"*** – Footnote 9 to paragraph 2.15 of the CP is a welcome clarification on the intended scope of COBS 22.2 (and COBS 4.14 currently in force). However, the proposed definition of *"contingent convertible instrument"* still contains some ambiguity. We have therefore set out in Part A of Annex 2 suggested options for the definition and discuss the approach we have taken in our answer to Question 2 below.

9. This is not to say that firms are trying to minimise their obligations and will disregard the PMR if they are distributing something that is not strictly caught by the PMR (see answer to Question 2 below), but it is important that firms know precisely when the PMR is applicable because it affects the language that might be used in relation to a transaction (e.g. in a prospectus or other communications with investors).

10. ***Restriction – "A <u>firm</u> must not…" -*** It would be helpful if the FCA could explicitly state its position with respect to the "firms" caught by the restrictions. We assume that the PMR would apply to an "incoming EEA firm" (as defined in the FCA Glossary) operating from a UK branch, whereas (in the absence of a specific provision to the contrary such as COBS 4.1.9G in relation to the restrictions on the promotion of non-mainstream pooled investments) the PMR would <u>not</u> apply to an "incoming EEA firm" operating on a cross border basis into the UK. Nevertheless, guidance in this area would be helpful.

11. ***Restriction – "retail client" -*** It is not clear how the ability of clients to opt up or opt down from their MiFID client categorisation interacts with the PMR. Paragraphs 2.16 and 2.31 of the CP state that the rules have no effect in relation to the distribution of CoCos to professional or institutional clients or eligible counterparties. In addition, the exemptions are drafted to relate to individual investors. It would therefore seem that the FCA is intending to restrict the distribution of CoCos to retail investors who are individuals, as opposed to an institution who has chosen to be treated as a retail client in particular circumstances. **As such, COBS 22.2.1R should be amended to refer to a "*retail client* in the *EEA* <u>who is an individual</u>…".**

12. ***Restriction – "retail client in the EEA"*** – The scope of these words is unclear. It could mean that the restriction relates to retail clients ordinarily resident in the EEA (even if they receive the promotion outside the EEA). However, it could also be interpreted to mean that the restriction relates to any retail client situated in the EEA at the time the promotion is made (even if they are ordinarily resident outside the EEA). It would be helpful if the FCA could provide some clarity on this.

13. ***Restriction – "beneficial interest in CoCos" and impact on discretionary management –*** It is not clear whether the restriction in COBS 22.2 would prevent a firm promoting CoCos to a discretionary investment manager who manages a portfolio or fund on behalf of ordinary retail investors. From a policy perspective, there is no reason why the PMR should do so. The PMR appears to stem from a concern that mass retail investors cannot understand the risks associated with CoCos, and only retail investors who are sophisticated enough to understand CoCos, or wealthy enough to bear the potential losses, should be allowed to invest in them. A sale of CoCos to a discretionary investment manager who manages a portfolio on behalf of a retail client and takes all decisions in relation to it in accordance with MiFID should therefore not be restricted. Such an approach is supported by proposed COBS 9.3.5G(3)(b), which details specific suitability assessments for discretionary investment managers. It would also be in line with the UK's implementation of AIFMD (see PERG 8.37.9(3)).This seems to be the FCA's intention,

because the word “holding” in COBS 4.14.1 currently in force has been replaced with “buying” in the proposed PMR, implying that the FCA wants to restrict the act of buying and associated investment decisions being made by mass retail investors, rather than retail investors passively holding an indirect beneficial interest in a CoCo as a result of an investment decision taken by a professional, such as a discretionary investment manager. **However, this is not clear and so it would be helpful if the FCA could include a specific exemption for promotions to discretionary investment managers.** (In addition to the policy point, many legal systems outside the UK do not recognise “beneficial interests”, and so it is not clear how this aspect of the rules applies outside of the UK.)

14. ***Restriction – “anything else that would or might result in”*** – These words imply that firms are not only responsible for their own actions, but that they also need to consider what might happen once they have sold the securities i.e. they could be responsible for ‘indirect’ sales or promotions of CoCos. For example, when UK bank A promotes to German intermediary B, it would appear that the PMR requires UK bank A to take reasonable steps to satisfy itself that German intermediary B will act in accordance with the PMR in relation to the securities, otherwise UK bank A’s promotion to German intermediary B could be something that “might result in” the securities ending up in retail hands. On the face of it, this broad drafting might seem sensible to achieve the FCA’s aim of ensuring ordinary retail investors in the EEA do not buy CoCos. However, this broad approach leads to some difficulties in practice.

15. First, the exemptions appear to be drafted to apply to the firm that is making the eventual promotion or sale to a retail investor. Imagine German intermediary B in our example sells to UK intermediary C, who sells to a UK certified high net worth investor in compliance with COBS 22.2.2. It is not clear that UK bank A’s activities are exempt in the way that UK intermediary C’s activities are exempt, because UK bank A as “the firm” for the purpose of the rules would not have satisfied the additional conditions to the exemption itself. And so on a strict reading of the rules, UK bank A could still be held responsible for doing something that resulted in a retail investor in the EEA holding the CoCo, and there is no exemption available to it. We do not believe this is how the PMR is intended to work. Rather, we expect that UK bank A would be able to promote to German intermediary B if it has taken reasonable steps to satisfy itself that German intermediary B will promote in accordance with the principles of the PMR.

16. This approach is supported by the statement in paragraph 2.23 of the CP: “Firms would be able to rely on representations from third parties that there would be no distribution to ordinary retail investors (provided such reliance is permitted under COBS 2.4)”. On the other hand, the statements in paragraph 2.20 of the CP could be read to imply that UK bank A, in our example, needs to obtain information about German intermediary B’s end client. However, that would not seem necessary given the apparent purpose of the PMR would be fulfilled by UK bank A taking reasonable steps to satisfy itself that German intermediary B will promote and on-sell in accordance with the principles of the PMR. On a related point, paragraph 2.9 of the CP states that distribution via mass-market intermediaries is unlikely to be compatible with issuers’ obligations under the PMR. However, it should be possible under the PMR for issuers and lead managers to promote and sell to mass-market intermediaries if they have taken reasonable steps to satisfy themselves that the mass-market intermediary will only promote to the relevant sub-set of their clients who fall into one of the exemptions contained in the PMR.

17. Secondly, the position is problematic for firms trading CoCos in the secondary market on exchanges where the identity of the counterparty cannot be known in advance (i.e. a bank’s offer can be accepted by any person trading on the exchange). While counterparties will generally not be retail clients who are individuals, there is no way of knowing whether the person who has accepted your offer is a counterparty who might then promote or sell to an individual. So for any promotion made in the context of secondary market trading on an exchange, there is no way that firms can know if they have done something that

"might result in" a retail investor in the EEA buying a CoCo and there is no way of taking reasonable steps to ensure that one of the exemptions applies, unless the exchange itself provides some assistance in this regard.

18. A more workable position than the one currently proposed in the PMR would be to restrict firms doing something that might **reasonably be expected to** result in an individual buying a CoCo (while also maintaining the safeharbour in COBS 22.2.1R(2)). We have suggested some drafting for that in Part B of Annex 2 to this response.

19. An additional step that would help to address these issues is to include a new provision in COBS 22.2.1(R) related specifically to "indirect" sales i.e. where a firm is promoting and selling CoCos to a financial intermediary who may on-sell to retail clients. We discuss this further in paragraph 23 below.

20. The combination of these suggested provisions would also help firms to continue to trade CoCos in the secondary market on electronic trading platforms (or exchanges in certain circumstances). This will assist secondary market liquidity in CoCos, which is essential to allow banks to continue to issue these securities in the primary market and raise the capital they need.

21. ***Exemptions – "broadly equivalent" limbs*** - The principle behind the widening of certain exemptions to include individuals in an EEA State other than the UK who meets requirements which are "broadly equivalent" to those set out in the TMR exemptions is welcome, as are the statements in paragraph 2.21 and 2.22 of the CP. However, it is not clear whether the "broadly equivalent" exemptions would require a local law that is "broadly equivalent" to COBS 4.12.6/7/8R, or whether the FCA is expecting UK firms to ask non-UK intermediaries to impose "broadly equivalent" standards upon themselves. Either option presents difficulties. If a "broadly equivalent" category of investor needs to be enshrined in the local law of the non-UK financial intermediary, this is problematic because we understand that very few jurisdictions outside the UK actually have rules that could be said to be "broadly equivalent" to COBS 4.12.6/7/8R. And even if they did, it is not clear which part of COBS 4.12.6/7/8R would need to be equivalent in order to satisfy the exemption and how close the local rules need to be to the COBS rules in order to be "broadly equivalent". Moreover, in order to avail themselves of these exemptions, it would seem that firms might need to check (as part of their "reasonable steps") all relevant local laws in order to ensure they are "broadly equivalent". That would be a costly and time-consuming exercise that would need to be kept under review (in case local laws change) and is likely to be unworkable in practice. It is also problematic if it is expected that UK firms will need to take reasonable steps to satisfy themselves that non-UK intermediaries are using "broadly equivalent" exemptions, even though such exemptions are not enshrined in their local law. This would entail the UK firms trying to explain and impose UK regulatory concepts to non-UK firms, by asking them to apply "broadly equivalent" standards (which, in line with footnote 10 to the CP, would seemingly need to at least meet the UK criteria). There is likely to be some reluctance among UK firms to be seen by other EEA regulators to be imposing through contract what is essentially UK gold plating and superimposing it on top of a regime already deemed adequate by such other regulators. Moreover, the "broadly equivalent" standard is not clear and certain enough to be explained by UK firms to non-UK financial intermediaries, and will therefore be extremely difficult to implement in practice. This problem is compounded by the FCA's guidance statements regarding suitability, which we discuss in our response to Question 7 below. Whatever solution is developed in this area should be considered from the perspective of practical implementation – in other words, whether it will be simple to explain to the EEA intermediary who will have to comply with the restrictions imposed on it.

22. Also, the additional conditions for the certified high net worth investor and self-certified sophisticated investor exemptions still require “the firm” to consider suitability for the individual investor. That condition does not work generally in relation to indirect sales (see paragraph 15 above), but it also does not work when a UK lead manager sells to a non-UK distributor, who might on-sell to a non-UK retail client. In that case, not only will the person assessing suitability not be “the firm” seeking to rely on the exemption, they will not even be a “firm”. So even with the addition of the “broadly equivalent” limbs, promotion and sale by UK firms to non-UK intermediaries is still problematic under the PMR as it is currently drafted.

23. A clearer and more precise approach which would address both the concerns regarding “indirect” promotions to retail investors and the concerns surrounding promotions to non-UK retail investors and non-UK financial intermediaries would be to include a separate provision in COBS 22.2.1R stating that the restriction does not apply where a firm has taken reasonable steps to satisfy itself that the person to whom it is promoting relevant securities (its counterparty) will not sell or offer those securities or do anything that would reasonably be expected to result in the buying of such securities by an individual retail client in the EEA, other than where (i) the counterparty has conducted an assessment and concluded that the relevant retail client understands the risks of an investment in the securities or is able to bear the potential losses involved in the investment in the securities and (ii) where the counterparty is acting in accordance with MiFID (or, where MiFID does not apply, in a manner that would be in compliance with MiFID if it did apply). We have suggested some drafting for such additional provision in Part C of Annex 2 to this response.

24. This approach aligns with what appears to be the FCA’s intention for how the rules should work, by restricting the distribution of CoCos to retail investors other than to those who can understand the security (i.e. sophisticated investors) or can bear the possible loss associated with it (i.e. high net worth investors). It also has the fundamental benefit of being a clear and simple rule that firms will be able to apply in practice to their business with financial intermediary counterparties who might on-sell to retail investors.

25. Imposing anything other than a clear and practical regime runs the risk that banks will not be able to apply the rules in practice and will therefore decide to exit the market, rather than take the possible regulatory risk associated with offering and trading CoCos. This could increase the cost of this type of regulatory capital for issuers.

26. ***Exemptions – Prospectus*** – The words “distribution of a prospectus required under the Prospectus Directive” are unclear. This could mean that anyone sending a prospectus that is required under the PD by any means and to any person is exempt from the PMR. However, it would seem from the general principles behind the rules that the FCA is intending the exemption to be narrower than that, and that only the prospectus publication in the manner required by applicable law, regulation or the rules of the relevant stock exchange is exempt from the rules. It would be helpful if this exemption could be clarified in order to ensure its scope is clear. The exemption should also apply to listing particulars.

27. ***Exemptions – MiFID or equivalent third country business –*** The language described in paragraph 23 above would also address another technical issue with the proposed rules. A manager's activities in underwriting and selling an issuer's securities would normally constitute "MiFID or equivalent third country business". However, it is unclear what COBS 22.2.2 means when it says "that rule only applies to the extent that the prohibited activity is the communication or approval of a financial promotion". It is difficult to apply this literally in the context of COBS 22.2.1R(2), which requires the firm to take reasonable steps to ensure that the exemption applies. Our understanding of this is that the prohibition

in COBS 22.2.1 only applies to the extent that the activities in question are the issue or approval of a financial promotion (and this is in line with statements in paragraph 2.24 of the CP), but that the manager would still have to assess whether that financial promotion would or might result in retail clients buying the securities. In that event, the manager would presumably have to establish that it took reasonable steps to ensure that the communication or approval of the financial promotion would not result in the promotion being distributed to EEA retail clients except in the circumstances where one of the *other* exemptions applies (as described in paragraph 15). However, this is not clear from the way the provisions are currently structured. As mentioned, this concern would fall away if the language suggested at Part C of Annex 2 is included in the PMR.

28. ***Exemptions – Format*** – More generally, the table format used for setting out the exemptions is confusing. In particular, the "additional conditions" column appears to be used to explain the exemption rather than set out an additional condition to the exemption in some cases. This is the case for MiFID, Prospectus, Issuers, Clearing, custodial and processing services and Indirect Investment exemptions. On the other hand, COBS 22.2.3R (2) and (3) do appear to set out additional conditions for certain exemptions, but they do not form part of the "additional conditions" column. Note 1 and Note 2 are not exemptions but are included at the end of the exemptions table. It would be helpful if these were separated from the table and/or included in the table at the relevant place(s) rather than forming part of the exemptions. It would also be helpful if the exemptions were numbered. Another drafting point to note is that the change from "prohibition" to "restriction" has not always been carried through, e.g. in the MiFID exemption.

CONCERNS WITH OTHER STATEMENTS IN THE CONSULTATION PAPER

29. Aside from the points raised above relating to the PMR proposals themselves, we note the following points on other statements in the CP.

30. The statements in paragraphs 2.3 and 2.13 of the CP regarding CoCos being "designed to meet the needs of issuers" and "not investment products designed to meet the needs of investors" seem to suggest that other types of debt securities are designed and issued to meet the needs of investors rather than the issuer. However most other bonds are issued by the issuer to meet their funding needs (or, in the case of CoCos, capital needs). We believe there is nothing inherently wrong with this approach, and firms are aware of their obligations under the FCA Principles and The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD).

31. The references in footnote 7 of the CP to "core" equity tier 1 capital should be references to "common" equity tier 1 capital.

32. The list of main characteristics of T2 debt in footnote 8 of the CP is incorrect. Some of the main characteristics of T2 debt are: dated securities with a minimum maturity of 5 years; holders' claims are subordinated to holders of non-subordinated debt; coupons are not deferrable or cancellable; there are limited events of default.

Q2: Do you believe the risks of inappropriate distribution identified in this paper apply to other types of CoCo, for example, those that may be issued by credit institutions outside the EEA, or by insurers in the EEA?

33. Logically, it would seem that products that share characteristics with, or are similar in nature to, products that are caught by the PMR might also be unsuitable for mass retail investors for the same reasons that CoCos are deemed to be unsuitable for mass retail investors. The risks of inappropriate distribution of those other products are the same as those that apply to CoCos. Indeed, firms are already conscious of

the read across from the FCA's and other regulators' statements in relation to CoCos to other similar products. Firms are therefore already considering their obligations under MiFID and the FCA Principles in relation to such similar products following the publication of the TMR and various statements and publications by regulators in other jurisdictions. We therefore do not believe as a matter of principle that detailed rules such as the TMR and the proposed PMR are necessary in relation to a broader category of products because firms already take steps to mitigate the risks of inappropriate distribution (particularly in light of the TMR and proposed PMR). Indeed, we believe that this sort of problem should be dealt with through the normal mechanisms of MiFID, notably through enforcement of the appropriateness and suitability regimes against financial intermediaries who mis-sell products. Overuse of product intervention not only risks subverting those regimes, through market participants assuming that, if there is no intervention, the product must be suitable; but also, as a consequence, may result in an informal regulatory kitemarking regime.

34. Nevertheless, given the PMR is due to come into force in October 2015 and UK firms will have to comply with it, it is important that firms have certainty as to when it will apply so that they can determine whether to refer to the PMR or not in their communications. Based on the policy statements made in the CP, it would seem that the FCA is intending to catch any regulatory capital instrument issued by a credit institution, investment firm or holding company thereof that converts to equity or is written down on the occurrence of a capital ratio based trigger, regardless of the jurisdiction in which the issuer is located. We have suggested two alternative options in Part A of Annex 2 for defining CoCos issued by credit institutions, investment firms or holding companies thereof. Option 1 is a "features based" definition. Option 2 maintains the approach currently taken by the FCA of referring to the CRR in relation to CoCos issued by EU issuers and has an additional limb for CoCos issued by non-EU issuers.

35. Given the CP generally refers to bank capital, we assume that the FCA will consider the position with regard to CoCos issued by insurance companies if and when this product develops, while bearing in mind the points made in paragraph 33.

Q3: Do you agree with our proposal to require records to be kept for each promotion or sale of these instruments to retail clients?

36. The general principle that firms should keep records in relation to direct promotions or sales of CoCos to retail clients is understandable. However, COBS 22.2.5R is broader than this, because it requires specific records to be kept for any activity subject to COBS 22.2. This would therefore appear to include promotions made by large firms lead managing new issues of CoCos and trading securities in the secondary market. While such firms will seek to put in place systems and controls to demonstrate adherence to the PMR (which would likely involve reviewing existing systems and controls related to marketing restrictions to ensure they satisfy the PMR), the proposed specific record keeping requirements appear to be very onerous and serve to highlight further the problems with how the restriction and exemptions themselves are structured. They appear to have been drafted with small firms that promote and sell securities directly to retail investors in mind, and do not reflect the realities of large firms' businesses, where sales teams will be interacting with financial intermediaries rather than retail clients directly. The record keeping requirements should be amended to reflect the realities of large firms' businesses (who will not be promoting CoCos directly to retail investors) and be workable in practice.

37. Specifically, COBS 22.2.5R(3) would appear to require a lead manager acting for an issuer in the primary distribution of CoCos to detail and record the exemption that applied to every single communication and other action within the scope of the PMR. There could be hundreds of such communications and actions, often made within a short period of time. It would therefore be unworkable to prepare a record in

respect of every single communication. The rules should be proportionate and capable of implementation by the firms that are subject to them. We do not think that the proposals are in line with this.

38. COBS 22.2.5R(3) and COBS 22.2.5R(4) (which requires firms who rely on certain exemptions to include a copy of the investor certificate or statement in their records) also serve to highlight further the problems with the structure of the rules noted above. Because the rules appear to restrict "indirect" promotions and distributions of CoCos (via the "anything else that would or might result" language), a UK lead manager of a primary issue of CoCos will take reasonable steps to satisfy itself that the persons to whom it sells securities in the primary distribution will comply with the principles of the PMR (e.g. UK bank A selling to German intermediary B would take reasonable steps to satisfy itself that German intermediary B will comply with the principles of the PMR). If German intermediary B promotes to a retail investor in the EEA, how can UK bank A detail the exemption that was relied upon (that is assuming that UK bank A can benefit from the exemption which is currently unclear – see paragraph 15 above)? UK bank A will not know the exemption(s) upon which German intermediary B might rely if it promotes to retail investors. And even if it did, it would not have access to the investor statements or certificates referenced in COBS 22.2.5R(4). It is therefore not clear how lead managers would be able to comply fully with this requirement.

39. A more proportionate approach would be to require firms to keep records in relation to the steps they take to satisfy themselves that each client to whom they promote relevant securities is aware of, and will act in a manner that is compliant with, the principles of the PMR. For example, if a firm has conducted appropriate due diligence and is satisfied that client X is not a retail client and reasonably believes that client X will only promote securities to retail clients in accordance with the principles of the PMR, and it has made a record of that assessment (which would be reviewed and refreshed on a periodic basis), it should be able to promote and sell CoCos to client X without needing to record the individual compliance of every single promotion and sale to client X. In other words, **the record-keeping requirement should relate to firms' steps at the level of its general client relationships (refreshed on a periodic basis), rather than at the level of each and every promotion to an individual client.**

Q4: Do you agree with our proposal to require the compliance department to confirm the compliance of each promotion or sale?

40. The compliance departments of firms will already be heavily involved in ensuring firms have systems and controls in place to ensure compliance with the PMR (and currently the TMR). However, while the compliance team set the internal compliance policies, it is for the sales and other relevant teams to act in accordance with those policies. Sales teams do not report to the compliance department and compliance officers are not, and cannot be, involved in every individual promotion. Requiring the compliance department to confirm the compliance of each promotion or sale (which is the approach that appears to be envisaged by the PMR as the delegation of record keeping can only be made to one or more employees who report to and are supervised by the person allocated the compliance oversight function of the firm) implies that compliance with the PMR is the responsibility of the compliance department and not other functions within the business, which is not the case and could not work in practice. The sales and other relevant teams within a firm (as Approved Persons) are just as responsible for ensuring compliance with relevant regulation as the compliance department itself, and the rules should reflect this. Appearing to transfer the responsibility for compliance and, by extension, conduct to the compliance department is out of step with statements made by the FCA regarding conduct being "firmly rooted in the

first line [of defence]"[3] and sends a counterproductive message. Such requirements will also lead to additional compliance costs with no apparent benefit for consumers: protection for mass retail investors lies in the restriction itself, not in a firm's detailed records of compliance.

41. A workable and proportionate approach would be to build upon the high level principle in SYSC 3.1.1 (which states that firms should have systems and controls in place that are appropriate to its business), by requiring the compliance department of a firm to have a policy in place for compliance with the PMR. As with other compliance policies, this would be subject to periodic review under SYSC 3.1.2(2). More detailed and prescriptive requirements are unnecessary and potentially unworkable for large firms for the reasons stated above.

Q5: Do you agree that the person responsible for compliance function oversight in the firm must review the approval process for compliance confirmation on at least an annual basis?

42. As noted above, the proposal for certification of compliance of each and every promotion affected by the PMR is unworkable and disproportionate for large firms. It is sensible, though, for the compliance department of firms to review compliance policies on a periodic basis. SYSC 3.1.2(2) already requires firms to review its systems and controls on a regular basis. It is also in a firm's self-interest to ensure that its compliance policies are reviewed and maintained. As such, it is not clear why compliance with the PMR should specifically require an annual review. The drafting of the rules should be left open to allow firms the flexibility to review their policies with the frequency that is appropriate for their own business and circumstances, rather than being mandated in the PMR.

Q6: Do you agree with our proposal to apply the same restrictions to pooled investments in CoCos?

43. We understand the principle behind the expansion of the position under the FCA's TMR to apply not only to promotions of CoCos but to promotions of securities issued by a CoCo fund.

44. However, there is a confusing statement in the CP regarding pooled investments. On the face of it, the PMR is drafted to restrict promotion of securities issued by a "CoCo fund". But the implication of paragraph 2.33 of the CP and the words "provided it is not a CoCo fund" in the Indirect Investment exemption is that there is a restriction on investment via a fund that invests wholly or predominantly in CoCos. In other words, it is implied that the PMR is intended to restrict firms promoting CoCos to a CoCo fund if the CoCo fund sells its units or shares to mass retail investors. If this is the intention of the rules, then there are a number of significant problems with this proposal.

45. First, it is not clear on the face of the rules that this is how they are intended to work, meaning firms will not have certainty as to whether their actions are prohibited or not. Taken to its logical conclusion, it could imply that the promotion and sale of CoCos to pension funds managing assets on behalf of mass retail investors (other than those which are exempt under the Indirect Investment exemption) might be prohibited. However, this is not clear on the face of the rules.

46. Secondly, it is likely to be very difficult for firms to implement such a restriction in practice, because it might mean that firms need to carry out PMR-related ongoing due diligence on *all* the counterparties they deal with (in addition to complying with their ongoing KYC obligations). This is because institutional asset managers will often invest in CoCos via a segregated "CoCo fund". There might be no indirect retail

[3] See Clive Adamson's speech "A sustainable conduct environment": http://www.fca.org.uk/news/a-sustainable-conduct-environment

interest in the fund, but a lead manager may still feel it necessary to carry out ongoing due diligence on this type of counterparty if the PMR extends to restricting promotions to a "CoCo fund". This represents a cost to the industry with no corresponding benefit for consumers (see paragraph 47 below). Furthermore, given the wide variety of legal vehicles that might be used to invest in CoCos and the fact that it will not be possible to discover who owns some such vehicles, it may be very difficult to carry out the due diligence.

47. Thirdly, and perhaps most importantly, there does not appear to be any policy reason for restricting promotions of CoCos to a fund that invests wholly or predominantly in CoCos. If the PMR is based on the premise that CoCos are too difficult for a mass retail investor to understand, then promotion and sale of CoCos to a CoCo fund manager (provided that CoCo fund manager is a discretionary investment manager) should be permissible. The identity of the investors in the CoCo fund should not matter, because the investment decision is taken by someone who is capable of understanding the risks associated with the product.

48. **It would be helpful if the FCA were to confirm that it is intending to restrict promotion of securities issued by a CoCo fund (which appears to be the case on the face of the proposed rules) and not promotion of CoCos to a CoCo fund, by amending the Indirect Investment exemption and including a statement to this effect in the document it publishes with the final PMR.**

Q7: Do you have any comments on the Guidance we propose for the classification of retail clients as sophisticated for the purpose of investment in loss-absorbing regulatory capital?

49. We understand the principle that the FCA is trying to convey in COBS 22.2.4G, namely the idea noted in paragraphs 2.18 and 2.39 of the CP that it is only a sub-set of sophisticated investors who are able to understand CoCos and therefore for whom CoCos will be suitable. However, this concept goes to the MiFID assessment of suitability by financial intermediaries who are selling relevant instruments. It is not necessary or appropriate to narrow the scope of the exemptions in respect of promotions restricted by the PMR. The PMR and the exemptions need to stand on their own, not least so that firms have certainty in relation to their compliance with it.

50. Specifically, COBS 22.2.4G appears to narrow the scope of the "Certified sophisticated investor" exemption. Paragraphs 2.18 and 2.39 of the CP could be interpreted as narrowing the scope of the "Certified high net worth investor" and "Self-certified sophisticated investor" exemptions due to the suitability assessment required under the "additional conditions" to those exemptions.

51. It is not necessary to narrow the scope of the exemptions in this way because the general suitability/appropriateness assessment requirements under MiFID should be sufficient to obtain an exemption under the PMR. Adding this extra layer of guidance creates uncertainty as to the availability of the exemptions. This would impact in particular on lead managers who are promoting CoCos in a cross-border offering. Taking the example we used in paragraph 14 above, in light of paragraph 2.18 and 2.39 of the CP and COBS 22.2.4G, it would seem that UK lead manager A would need to take reasonable steps to satisfy itself that German intermediary B will not only promote and sell to investors who meet the exemptions as they appear on their face, but would further need to demand that German intermediary B restrict its distribution to the very small sub-set of investors who meet the parameters of the guidance statements. This will be almost impossible for UK lead manager A to achieve in practice. Not only do the concepts in the guidance go over and above MiFID principles but, in some respects, they are open to interpretation (see paragraph 53). Moreover, UK lead manager A would not be telling German intermediary B to comply with clear UK legislation (which in itself presents political problems as discussed in paragraph 21), but going beyond that to require German intermediary B to comply with soft guidance

statements from the UK regulator; all in circumstances when it is not clear that the guidance is intended to narrow the scope of the exemptions.

52. The FCA's approach also seems odd when one considers the comparison between understanding the risks involved in an investment in CoCos versus an investment in a bank's ordinary shares. A share's price is affected by a number of different, potentially complex, factors that may well not be understood by a mass retail investor. Moreover, the risk profile of a CoCo is similar to an ordinary share in a bank, in that an investor is likely to lose all or most of its investment if the issuer gets in to difficulty. From an investor's perspective, the analysis of how likely it is that you will lose all or most of your investment in bank shares versus CoCos is very similar; and the information available to investors in shares and CoCos is the same. It therefore seems odd that the FCA is not only proposing to restrict the distribution of CoCos to mass retail investors, but going further to suggest that only a very narrow sub-set of sophisticated investors should be able to invest in them. The promotion and distribution of ordinary shares is not restricted in this way, and investors are not required to have <u>any</u> level of sophistication for an investment in a bank's ordinary shares.

53. COBS 22.2.4G is also unclear. For example, is the reference to "extensive experience in multiple types of complex financial instruments" in COBS 22.2.4G intended to be extensive experience of <u>investing in</u> multiple types of complex financial instruments, or is some other experience required? And the reference to "sufficiently in-depth understanding of how credit institutions are run" is unclear. Is it intended to mean that only people who are (or have been) involved in running a bank are seen as sophisticated for the purposes of COBS 22.2.4G? If so, this narrows the scope of investors who fall within the certified sophisticated investor exemption almost to the point where it is redundant as an exemption, because the number of investors who meet the criteria is so small. We do not think this can be the intention of the FCA, because the exemption was included in COBS 22.2.2R.

54. In light of the above, it may not be possible for UK lead manager A in our example to feel reasonably satisfied that it is able to promote securities to financial intermediaries. The consequences of the certified high net worth, certified sophisticated and self-certified sophisticated investor exemptions becoming unavailable in practice (even if they are set out in the rules) would be that FCA firms might look to stop promoting and selling CoCos to private banks and other financial intermediaries in the primary market and trading with them in the secondary market altogether, because they do not feel comfortable taking the regulatory risk associated with doing so. Having a broad and diverse pool of investors for any product could always be deemed to be beneficial to that product's liquidity. The exact effect of firms ceasing to promote and sell CoCos to private banks and financial intermediaries in the primary market is difficult to predict but an inability to trade with these firms in the secondary market could inhibit liquidity. The consequences of reduced liquidity and a narrowing of the pool of investors for a product are also hard to identify with precision, but could potentially affect the price of that product and lead to a reduction in the capacity of issuance of that product. It is worthwhile noting that any impact on pricing or capacity to issue in the primary market would not only be borne by UK issuers, but also non-UK issuers of CoCos where FCA-authorised firms are mandated to lead manage the new issue.

55. **In order to address the concerns above, COBS 22.2.4G should be deleted. It would also be helpful if the FCA confirmed that the statements in paragraphs 2.18 and 2.39 are intended to apply only to determinations of suitability or appropriateness under MiFID by the intermediary dealing with the individual retail investor, and not to promotion to that intermediary or that individual.**

C. FCA QUESTIONS ON COST BENEFIT ANALYSIS

Q18: Do you have any comments on our cost benefit analysis for the proposals relating to CoCos, pooled investments in CoCos and mutual society shares?

56. As a general point, the cost benefit analysis for the permanent rules is welcome. However, significant upfront compliance and legal costs have already been incurred by firms in connection with the introduction of the TMR. This does not seem to be acknowledged in the CP. Indeed, paragraphs 28 and 29 of the Cost Benefit Analysis appear to state that there is currently only a "supervisory approach" in place, which is not the case.

57. The FCA states at paragraph 25 of the Cost Benefit Analysis "It may be the case that issuers turn to retail customers if institutional investors require better terms and conditions or if there is insufficient demand for any other reason". This statement appears to miss the fact that, regardless of their capital position, firms are subject to MiFID obligations, the FCA Principles and The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD), which are all in place to prevent inappropriate distribution of securities, including CoCos.

58. The FCA states at paragraph 31 of the Cost Benefit Analysis: "The proposals will only have an impact on firms that sell these instruments to retail consumers. Where firms do not include retail investors in their customer base, they will not need to make any changes to their processes". We do not consider this to be correct. As discussed in our response to Question 1, the proposed PMR restricts firms' direct promotions to retail investors and also "anything else that would or might result in" a retail client holding a CoCo. In light of this, firms who promote and sell CoCos to financial intermediaries (either in the primary or secondary market) would presumably need to take reasonable steps to check that those financial intermediaries will act in compliance with the principles of the PMR. This would require a great deal of work and cost relating to (i) carrying out due diligence on counterparties, (ii) re-papering client relationships, (iii) taking additional steps on the issuance of a CoCo for lead managers to be reasonably satisfied that any financial intermediaries in the order book will comply with the principles of the PMR, (iv) establishing and maintaining systems and controls for compliance with the PMR and (v) training staff. The firms subject to such costs generally do not include retail investors in their customer base. The Cost Benefit Analysis therefore appears to be flawed, because it fails to account for the impact on large firms that lead manage issues of CoCos and trade CoCos and securities issued by CoCo funds with institutional and professional clients.

59. Aside from that fundamental point, some other aspects of the Cost Benefit Analysis could perhaps be re-visited by the FCA, such as:
    (i) the estimated incremental compliance costs set out in paragraph 34 do not appear to have any background or justification regarding how they were reached;
    (ii) the assumption that third party distributors will be medium firms in paragraph 36 is not a valid assumption, because lead managers of CoCos are likely to be large firms;
    (iii) the increase of 10% to reflect the costs associated with the distribution by UK firms to non-UK EEA clients in paragraph 44 does not appear to have a justification or basis;
    (iv) the hourly costs drawn from an "Estimation of FSA administrative burdens" is 9 years old (see footnote 42);
    (v) the statement that one-off costs relating to record keeping will be minimal at paragraph 58, given the concerns with the record keeping requirements we discuss in our response to Questions 3 and 4; and
    (vi) changes to "literature" are mentioned in the cost benefit analysis but are not specifically accounted for. Changes to prospectuses and other marketing materials to address the proposed restrictions

are indeed a cost that will be borne by issuers, lead managers and distributors and so should be included in the cost benefit analysis.

ANNEX 2

A. SUGGESTED LANGUAGE FOR DEFINITION OF "CONTINGENT CONVERTIBLE INSTRUMENT"

OPTION 1

"A *financial instrument* issued or guaranteed by a *credit institution*, an *investment firm* or a *holding company* thereof:

(1) where the claims of investors in relation to the relevant *financial instrument* or guarantee are subordinated to the claims of unsubordinated creditors (including, in the case of a *credit institution*, its depositors) of such *credit institution*, *investment firm* or *holding company* on the insolvency of the relevant *credit institution*, *investment firm* or *holding company*; and

(2) the contractual terms of which require the principal amount of such *financial instrument* to be written down on a temporary or permanent basis or such *financial instrument* to be converted into common equity tier 1 instruments in either case upon the occurrence of a breach of a capital ratio which is specified in the terms of such *financial instrument*."

OPTION 2

"(1) in the case of a *financial instrument* issued or guaranteed by a *credit institution*, an *investment firm* or a *holding company* thereof which is subject to primary prudential regulatory supervision in a member state of the European Union or (once the *EU CRR* is incorporated into national law in the relevant *EEA State*) an *EEA State*:

(a) Additional Tier 1 instruments under article 52; or

(b) Tier 2 instruments under article 63, the contractual terms of which require the principal amount of such Tier 2 instrument to be written down on a temporary or permanent basis or such Tier 2 instrument to be converted into common equity tier 1 instruments in either case upon the occurrence of a breach of a capital ratio which is specified in the terms of such Tier 2 instrument;

in each case of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012[4]; or

(2) in the case of a *financial instrument* issued or guaranteed by a *credit institution*, *investment firm* or a *holding company* thereof which is not subject to primary prudential regulatory supervision in a member state of the European Union or (once the *EU CRR* is incorporated into national law in the relevant *EEA State*) an *EEA State*, a *financial instrument*:

(a) that is (or is intended to be) eligible to count towards that entity's regulatory capital requirements on a solo or consolidated basis; and

[4] The FCA might also wish to consider replacing the reference to "Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012" with the FCA Glossary definition "*EU CRR*"

(b) the contractual terms of which require the principal amount of such *financial instrument* to be written down on a temporary or permanent basis or such *financial instrument* to be converted into common equity tier 1 instruments in either case upon the occurrence of a breach of a capital ratio which is specified in the terms of such *financial instrument*."

B. SUGGESTED AMENDMENT TO COBS 22.2.1R (1)

"A firm must not sell or do anything else that ~~would or~~ might reasonably be expected to result in a retail client in the EEA who is an individual buying…"

C. SUGGESTED LANGUAGE FOR NEW COBS 22.2.1R (4)

"The restriction in (1) does not apply if a *firm* has taken reasonable steps to satisfy itself that a counterparty to whom it promotes a *contingent convertible instrument* or a *security* issued by a *CoCo fund* or a beneficial interest in either of them will not sell or offer those securities or do anything that would reasonably be expected to result in the buying of such securities or beneficial interest by a retail client in the EEA who is an individual, other than where (i) the counterparty conducts an assessment and concludes that the relevant retail client understands the risks of an investment in the securities or is able to bear the potential losses involved in an investment in the securities and (ii) the counterparty acts in accordance with MiFID (or in a manner that would be in compliance with MiFID if MiFID were to apply to it)."