

Restrictions on the retail distribution of regulatory capital instruments

Feedback to CP14/23 and final rules

June 2015



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In this Policy Statement we report on the main issues arising from Consultation Paper 14/23 *Restrictions on the retail distribution of regulatory capital instruments* and publish the final rules.

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Abbreviations used in this paper

| | |
|---------------|---|
| AT1 | Additional tier 1 |
| CCDS | Core capital deferred share(s) |
| CET1 | Common equity tier 1 |
| COBS | Conduct of Business Sourcebook |
| CoCo | Contingent convertible security |
| CRD IV | Capital Requirements Directive IV |
| CRR | Capital Requirements Regulation |
| EEA | European Economic Area |
| ESAs | European Supervisory Authorities |
| ESMA | European Securities and Markets Authority |
| EU | European Union |
| FCA | Financial Conduct Authority |
| FSMA | Financial Services and Markets Act 2000 |
| MiFID | Markets in Financial Instruments Directive |
| PPDS | Profit participating deferred share(s) |
| PRIIPs | Packaged Retail Investment and Insurance-based Investment Products Regulation |
| SIPP | Self-invested personal pension |
| SYSC | Senior Management Arrangements, Systems and Controls Handbook |

1. Overview

Introduction

- 1.1** In this paper we set out the rules we are implementing following our consultation on restrictions on the retail distribution of regulatory capital instruments (contingent convertible securities (CoCos) and mutual society shares).¹

Who does this affect?

- 1.2** The paper will be relevant to:
- consumers and consumer organisations
 - firms that have issued or are considering issuing CoCos
 - firms that have issued or are considering issuing mutual society share instruments, in particular core capital deferred shares (CCDS)
 - firms involved with promotion, advice, sales or other transactions relating to these instruments
 - firms involved with the management, operation or distribution of securities issued by unregulated collective investment schemes, qualified investor schemes or special purpose vehicles investing wholly or predominantly in CoCos
 - trade bodies representing these firms
 - compliance consultants and other firms that assist distributors

Context

- 1.3** Novel types of regulatory capital instruments are being issued in large amounts as institutions transition their capital position to meet the new prudential requirements under the Capital Requirements Directive IV (CRD IV) and Capital Requirements Regulation (CRR) package of measures.

¹ CP14/23, *Restrictions on the retail distribution of regulatory capital instruments*, October 2014: www.fca.org.uk/static/documents/consultation-papers/cp14-23.pdf

- 1.4** We regard CoCos and common equity tier 1 (CET1) share instruments issued by mutual societies as posing particular risks of inappropriate distribution to ordinary retail customers.
- 1.5** In August 2014 we announced the introduction of temporary product intervention rules restricting the retail distribution of contingent convertible securities (CoCos).² The rules entered into force on 1 October 2014. We consulted in October last year on permanent rules to replace the temporary rules when they expire on 1 October 2015.
- 1.6** We also proposed the introduction of new requirements when certain regulatory share capital instruments issued by mutual societies, including CCDS, are distributed in the retail market.
- 1.7** Our proposals are designed to advance our objectives of securing an appropriate degree of consumer protection and promoting effective competition in the interests of consumers. The rules we have introduced will limit the scope for distribution that exploits information asymmetries and other consumer behavioural weaknesses, which are a particular concern where complex, risky instruments are offered to non-sophisticated retail investors of ordinary means. In doing so, the new rules should significantly limit the scope for consumer harm from inappropriate retail investment.

Summary of feedback and our response

- 1.8** We received 50 responses to the consultation, which closed on 29 January 2015. Respondents included individual investors, firms, trade bodies and other interested parties.

CoCos

- 1.9** CoCos are highly complex, hybrid capital instruments with unusual loss-absorbency features written into their contractual terms. While CoCos may be designed in a variety of ways and issued under a variety of names, one key characteristic is that CoCos feature an equity conversion or writing down trigger set with reference to the issuer's capital position in relation to regulatory requirements.
- 1.10** CoCos eligible towards issuers' Additional Tier 1 (AT1) capital also feature other unusual characteristics for non-equity instruments, in that they are permanent notes with entirely discretionary income payments. This means 'coupons' may be cancelled at any time, for any reason, and the notes might never be redeemed.
- 1.11** While CoCos can be designed in a range of different ways, all are highly complex instruments presenting investment risks that are exceptionally challenging to evaluate, model and price.
- 1.12** In the consultation paper, we proposed to make permanent the approach taken in the temporary rules.³ These rules prevent firms from distributing CoCos in the retail market without first checking that the prospective client meets certain criteria. In general terms, firms should not distribute these instruments to ordinary retail investors. We also proposed rules that will restrict the retail distribution of pooled investments that invest wholly or predominantly in CoCos.
- 1.13** Most of the responses we received relate to existing CoCos issued by one firm. Where investors had specific concerns that relate to individual securities, we have written to them directly.

² We are able to make temporary product intervention rules without prior consultation. These rules may last for a maximum of 12 months. Our announcement on the introduction of temporary rules for CoCos is available at: www.fca.org.uk/static/documents/temporary-product-interventions/restrictions-in-relation-to-the-retail-distribution-of-cocos.pdf

³ See COBS 22.1

Where their comments relate to the proposals on which we consulted, we have taken them into account as we developed our thinking.

1.14 A number of these existing CoCo investors argued that bank CoCos are less risky, easier to value and better regulated than other securities, and argued on that basis that we should not restrict retail distribution of CoCos.

1.15 Most industry respondents, on the other hand, tended to agree with our assessment of the risks involved and accepted the aims and intentions of the proposed rules. We received suggestions to clarify some of the rules and definitions, but, in the main, comments related to the following areas.

- The proposed rules apply to sales made to retail clients in the European Economic Area (EEA). Some respondents highlighted practical problems when dealing with intermediary firms based outside the UK.
- Some respondents consider our proposed requirements for record keeping and sale verification to be too onerous and to imply a switch of responsibility from the sales department to the compliance department.

1.16 We have considered the feedback and we still believe that the restrictions on retail distribution of CoCos currently in place represent a reasonable and proportionate regulatory response to the significant risk of harm to consumers that we have identified. We have, however, made some changes to the rules relative to the draft we consulted on to take account of some of the feedback we received from firms. In broad terms, we have changed the scope of these rules so they apply only when firms sell or promote (or approve promotions) to retail clients. Other intermediation activities that give effect to transactions in CoCos will not be in scope of the permanent rules.

Mutual society shares

1.17 The mutual society instruments of concern to us are also relatively unusual, complex and risky, and pose a significant risk of inappropriate distribution to non-sophisticated investors.

1.18 In this paper, references to 'mutual society share' are intended as reference to core capital instruments and not to other building society instruments or arrangements often described as 'shares'.⁴ Mutual society shares are deeply subordinated and perpetual instruments, and often offer poor liquidity. Income payments are typically capped and always discretionary, and investors do not have the usual rights of holders of company shares, such as voting in proportion to shareholding. The most recent mutual society share issuance has taken the form of CCDS, but slightly different forms may also be issued. As with CoCos, we are concerned that these securities are hard for investors to value and that their features may not fit naturally with the needs of ordinary retail investors.

1.19 However, we are mindful that mutual societies, particularly the smaller societies, may have little or no access to institutional markets to raise regulatory capital. We also recognise that the concept of mutuality entails ownership by members; some consumers may genuinely wish to support mutual societies of which they are members by providing core capital.

⁴ Not all mutual society shares are within the FCA's regulatory perimeter. For building societies, shares other than those defined as deferred shares for the purposes of s. 119 of the Building Societies Act 1986 are not specified investments under the FSMA 2000 (Regulated Activities) Order 2001 nor controlled investments under the FSMA 2000 (Financial Promotion) Order 2005. Similarly, generally speaking non-transferrable shares issued by other mutuals such as industrial and provident societies and credit unions are not specified investments.

- 1.20** With this in mind, we proposed to impose certain requirements on the distribution of mutual society shares to ordinary retail investors. We proposed that firms may distribute the securities to ordinary retail investors who receive prescribed risk warnings and who commit to limit their exposure to this type of security to no more than 5% of their net investable assets. The rules we proposed would apply only to the primary issuance and not to secondary market dealings. The requirements do not apply to sales of mutual society shares to institutional investors or to retail investors certified as sophisticated or high net worth (subject to the conditions of these exemptions being met).
- 1.21** Feedback was mixed. Some respondents argued that we should not impose any specific requirements on distribution. Some suggested we should treat mutual society shares in the same way as CoCos; that is, that our rules should not permit the distribution of mutual society shares to ordinary retail investors but only to those who are sophisticated or wealthy, or institutional investors. Some respondents accepted the general approach but suggested changes to the rules we proposed, mainly relating to record-keeping requirements and the investment 'cap', with a number of respondents suggesting we should apply the same figure (10% of net assets) as applicable to direct offer promotions of securities on crowdfunding platforms to ordinary retail investors. We have agreed to change the investment 'cap' for ordinary retail investors to 10%.

Next steps

- 1.22** The rules set out in Appendix 1 come into force later this year: on 1 July 2015 for mutual society shares and on 1 October 2015 for CoCos.
- 1.23** If your firm is affected by these rules, you should consider the changes you need to make.

2. Distribution restrictions for CoCos

- 2.1** This chapter summarises feedback to the questions in Chapter 2 of the consultation paper, in relation to the longer term approach to mitigating conduct risks arising from the retail distribution of CoCos.

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

- 2.2** In the consultation paper, we proposed rules that stop firms selling, promoting or intermediating transactions that would result in ordinary retail investors in the EEA investing in CoCos. To the extent a firm's activities amount to MiFID or equivalent third country business, the rules on which we consulted would only apply restrictions in relation to promotional activities and not to the sale or intermediation of the transaction in CoCos.
- 2.3** We received 37 responses to the question we posed on our proposals. Over half of the responses were from retail investors who already hold CoCos issued by one firm. The firm in question had recently announced its intention to exercise a contractual clause to redeem the securities at par.⁵
- 2.4** Generally speaking, those respondents felt it was unfair for the firm to seek to redeem the instruments; many were concerned about losing the income produced by the notes and loss of capital relative to market values for the notes. The instruments in question were Tier 2 securities with characteristics that arguably made them not as complex or risky as instruments that have been issued more recently, in particular CoCos designed to be eligible as AT1 capital. These existing CoCos have not triggered; if they had, investors would likely suffer far more extensive losses.
- 2.5** Responses relating to investors' concerns about their existing CoCos were dealt with separately as a supervisory matter. Some of these responses did, however, include feedback on the proposals put forward for consultation. Existing investors were generally of the view that CoCos should be distributed in the retail market without restriction. The main arguments put forward in support of their contention are:
- Not all risky investments are subject to restrictions on distribution; including others that are not designed for a retail investor base and/or that are as risky or riskier than CoCos.

⁵ This contractual clause was not the trigger point for the conversion of the instruments, but a specific clause in relation to these securities only.

- The risk of equity conversion of some CoCos is based on a defined trigger, which was said to be much easier for investors to evaluate and understand than the uncertain bail-in risks that apply to all bank securities under the Bank Recovery and Resolution Directive.
- Investors should be free to invest in whatever they choose.
- Banks and building societies are regulated, so their loss-absorbing securities are likely to be much more suitable for retail investors than other types of security, such as companies on the Alternative Investment Market (AIM) or equities sold via crowdfunding platforms.
- The restrictions on distribution do not align with changes to the ISA regime to allow CCDS to be held within the ISA wrapper and/or earlier regulatory support for their launch.⁶
- Other solutions, preferable to these respondents, included:
 - Changing the listing rules to ensure better protection of retail bondholders, including the right to formal representation in restructurings. It was suggested this could be achieved by the regulation of trustees, with formal duties owed to bondholders.
 - Requiring clearer or more prominent risk warnings, fairly presented and explained so all investors can understand them.
 - Restricting the freedom of credit institutions to use these instruments for loss absorbency purposes.
 - More extensive notification requirements to ensure that all retail investors (including those holding securities in a broker nominee account) are aware of any problems.
 - Requiring any offers, repurchases or exchanges to be made on equal terms to all holders.
 - Using independent experts to ensure fairness in relation to restructuring and introducing a requirement that issuers act with integrity toward the holders of listed securities.
 - Improving FCA investigation of market abuse claims.
 - Retail investor representation on FCA Panels and Boards.

Our response

In response to the points raised by these respondents, we note the following.

- Our consultation paper discussed general issues only. It would have been inappropriate to use it to discuss issues in a particular firm. We did, however, take account of the position of existing investors in developing the proposals.
- We have not intervened simply because these instruments are high risk or complex. We are concerned that ordinary retail investors are likely to be attracted to these securities and overlook or misunderstand their characteristics and risks. We consider that improved risk warnings are unlikely to mitigate

⁶ *The New ISA and changes to Junior ISA and the child trust fund: increasing flexibility for savers and investors: www.gov.uk/government/uploads/system/uploads/attachment_data/file/293798/TIIN_8079_9034_6234_8163_New_ISA_junior_ISA_and_CTF.pdf*

the significant risks of inappropriate retail distribution as identified.

- CCDS are not CoCos; they are a type of mutual society share. Our rules do not prevent the sale or promotion of mutual society shares to ordinary investors. Instead they impose additional requirements on firms when promoting or selling the securities to these investors (see the discussion in Chapter 3 for more detail). Our rules do not prevent investment in CCDS within the ISA wrapper.
- Some of the changes suggested by respondents would entail significant changes to how capital markets operate, as opposed to the more targeted intervention contained in our new rules. Many CoCos are issued outside the UK, so even if we were able to make changes to the listing rules in the way envisaged by some respondents, the rules would not apply to CoCos listed elsewhere, creating opportunities for regulatory arbitrage while leaving retail investors exposed to the risks we have sought to mitigate. We are not convinced a listing rules-based approach would be more effective or proportionate, and in any event the listing rules are largely derived from EU legislation and cannot easily be amended by UK regulators acting alone.
- CoCos are designed to absorb losses. It would not be appropriate for us to intervene in a way that undermines the intended prudential role of these instruments in the capital structure of the issuing credit institutions.
- We consider that our rules to restrict retail distribution of CoCos support prudential requirements for credit institutions to raise capital of sufficient loss absorbency. Our rules recognise that these highly-complex instruments may operate in ways even sophisticated investors do not expect, and generally speaking are inappropriate investments for retail investors of ordinary means and sophistication. Our rules do not affect promotion or sales to institutional investors who constitute the bulk of the market for these instruments, and who are much better positioned to evaluate and price the risks. Our rules also permit the promotion and sale of CoCos to retail investors who are sophisticated or high net worth (subject to conditions).
- Our rules are designed to advance our objective of securing an appropriate degree of consumer protection while promoting more effective competition in the interests of consumers. Consideration of retail investor needs has been central to our work.
- Regarding investor representation on FCA panels, the FCA Consumer Panel is an independent statutory body set up to represent the interests of consumers in the development of policy for the regulation of financial services.⁷ Recruitment to the Panel is an open process with vacancies advertised from time to time.
- We investigate market abuse claims and supervise compliance with market conduct rules. The risks our rules on CoCos are designed to address are not in the nature of market abuse but of inappropriate distribution to non-sophisticated retail investors.

⁷ www.fs-cp.org.uk/

2.6 Six other respondents disagreed with the proposals, making some similar points as set out above. They also made the following points.

- One respondent suggested that existing EU and UK regulations concerning the distribution of securities to retail investors already secure sufficient protection for investors. This respondent also suggested we consider the use of high minimum denominations as a way to prevent sales to unsophisticated retail investors.
- Another respondent suggested that instead of restricting retail distribution, it might be better to stop credit institutions selling CoCos to their own customers, as these customers may not understand the risks involved. Investors buying the securities online could be given the phone number of an agent who could check that the investor is aware of the risks.

Our response

We consider our approach to be consistent with existing EU and UK regulation. The European Securities and Markets Authority (ESMA), for example, has published a statement directed to institutional investors that outlines concerns that risks involved with investment in CoCos are being misunderstood or overlooked.⁸ They note that adequate investment analysis 'can only take place within the skill and resource set of knowledgeable institutional investors'. In other words, the statement supports our contention that ordinary retail investors lack the skills and resources necessary to evaluate and price the risks and potential benefits of CoCos.

We obtained voluntary agreement from a number of UK firms to issue CoCos in high minimum denominations while we worked on our longer term approach and before introducing the temporary rules last year. As many CoCos are issued outside the UK, an approach that relies on minimum denomination requirements could only apply to those firms that issue securities in the UK, and would not control distribution risks for securities issued elsewhere and sold into the UK.

We do not consider that preventing credit institutions selling CoCos to their own customers would be an appropriate response. It would not deal with the risks where other firms sell the instruments to ordinary retail investors, and would prevent credit institutions offering the securities to sophisticated and/or high net worth customers who would be better able to understand and afford the risks.

2.7 Eight respondents agreed broadly that the distribution of CoCos should be restricted in the retail market to reduce the scope for inappropriate investment. The respondents suggested certain changes to the rules to facilitate compliance.

⁸ ESMA, *Potential Risks Associated with Investing in Contingent Convertible Instruments*, 31 July 2014: www.esma.europa.eu/content/Potential-Risks-Associated-Investing-Contingent-Convertible-Instruments.

- It was suggested that the CoCo definition could be made clearer to help firms identify the instruments. One suggestion was to support the definition with guidance setting out the key characteristics of these financial instruments. Another was to require issuers, at least those subject to FCA oversight, to label their securities as CoCos or to require data providers and exchanges to develop relevant markers to enable the identification of the instruments. A third suggestion related to clarifying the definition with regard to certain Tier 2 instruments.⁹
- Four industry respondents were concerned about the application of the rules to firms dealing with clients outside the UK. The temporary rules and the draft rules on which we consulted apply to firms dealing with retail clients in the EEA. This, these respondents said, creates difficulties for UK-based firms that must try to control the activities of other 'downstream' firms based outside the UK. Linked to this, we were asked to consider setting out in more detail the criteria we expect to be met, for example with regard to the high net worth exemption, where firms are working with retail clients in other EEA jurisdictions where different classification criteria apply locally.
- More generally, we were asked how far we expect issuers to go in meeting their obligations under our rules, particularly where they deal with intermediaries who in turn arrange sales for retail investors. Some issuer firms are asking distributors to sign attestations confirming they adhere to the temporary rules when they sell to retail investors. One respondent suggested that it would be better to reword the rules so that they restrict firms doing something that might reasonably be expected to result in an individual buying a CoCo, and to clarify the situation where the ultimate sale is intermediated.
- To assist employee-incentive packages that encourage staff engagement with the group's overall performance, it was suggested that we add a further exemption in the rules to allow firms to offer CoCos to retail clients who are employees of either the issuing institution or firms in its group, or consider waivers to this effect.
- Some respondents asked us to clarify the position in relation to discretionary investment management services, in particular, whether a discretionary manager's decision to allocate CoCos to a retail investor's portfolio would be caught by the rules as creating a beneficial interest or amounting to 'indirect' investment in CoCos.
- One respondent suggested that the exemption for prospectus documents should be clarified, as it currently implies that the communications other than the prospectus could be provided to retail investors under the exemption.

2.8 We also received some comments about the format of the rules in this section.

Our response

In light of this feedback, we have made some amendments to our rules.

We have updated the CoCo definition to help firms distinguish Tier 2 CoCos from other Tier 2 instruments that are not in scope of these rules. We have not mandated that issuers label CoCos as such. Instruments issued by firms based outside the UK would remain unlabeled, which would create confusion

⁹ In the consultation paper, we noted that the rules apply to financial instruments eligible as Tier 2 capital under CRD IV / CRR, but only if they are CoCos, that is, if the contractual terms provide for writing down or conversion of the principal upon the occurrence of a 'going concern' trigger event set with reference to the issuer's common equity Tier 1 capital ratio.

for distributor firms. More generally, we expect firms operating in this market to have a sufficient understanding of the financial instruments they are dealing with, based on the characteristics of instruments and not just on how the instruments are named by issuers.

We are changing the scope of the rules so that the permanent rules will only apply to sales and approval and communication of promotions, and not to other activities by firms higher up the chain of distribution. We remind MiFID firms that do not deal with retail investors but which help in the design and distribution of CoCos that, from 2017, new product governance requirements will come into force obliging them to consider the correct target market for the instruments and to select appropriate distribution channels. More generally, we may also intervene as necessary in relation to firms which will not be subject to the permanent rules if we find that they are acting in a manner that undermines the effect of the restrictions on distribution of CoCos in the retail market.

The permanent rules for CoCos will come into effect on 1 October 2015, when the temporary rules expire. As the permanent rules are slightly different to the temporary rules, this will give firms time to adapt their systems. While the temporary rules remain in place, firms promoting, selling or otherwise enabling the sale of CoCos to retail investors in the EEA should continue to take reasonable steps to ensure the transaction is permitted under one or more of the exemptions provided for in COBS 22.1. What 'reasonable steps' amounts to will depend on the circumstances. Client certification requirements may be adapted to local circumstances (within reason). This has been made explicit in the permanent rules that will replace the temporary rules with effect from 1 October 2015. Firms are reminded of our rules in COBS 2.4 on treating agents as clients and reliance on other firms.

No exemption has been added to allow firms to offer CoCos to all of their employees. This does not prevent firms from including CoCos as part of employees' remuneration packages where the employee is given CoCos as part of their pay. Where employees are invited to buy CoCos, our rules mean that such offers should only be extended to employees who are sufficiently sophisticated or high net worth to be so categorised under our rules.

The prospectus exemption in our rules only applies to the distribution of a prospectus required under the Prospectus Directive. Other communications that accompany the prospectus are subject to the restrictions.

2.9 Some respondents asked questions to try to better understand our expectations:

- One respondent asked whether all CoCos should be treated in the same way by our rules, or whether those that meet certain specified criteria are safer.
- We were asked to clarify whether EEA firms selling into the UK on a services basis are subject to our rules. Related to this last point, we were asked to explain the exemption for MiFID or equivalent third country business. Specifically, we were asked if the restriction applies only to the approval or communication of financial promotions, or if the firm must still assess whether that promotion would or might result in retail clients buying the securities and whether those clients are within scope of another exemption.

- One respondent asked if the rules apply to a self-invested personal pension (SIPP) operator that receives an instruction from a client or their adviser to buy one of these instruments for the client's SIPP.
- We were asked to explain how the proposals apply to promotions of CoCos to discretionary investment managers.
- We were also asked how the rules apply where retail clients opt to be treated as professional clients, or professional clients opt to be treated as retail clients.

Our response

To answer these questions:

At this point in time we consider that CoCos of any kind should not be sold or promoted to ordinary retail investors.

Firms selling or promoting CoCos to retail clients are subject to the restrictions. In our view, this includes firms based outside the UK but promoting or selling into the UK on a services basis.

The exemption for MiFID or equivalent third country business means that only the approval or communication of a financial promotion is subject to the restriction for transactions within MiFID scope. Firms are reminded that investment advice that recommends the client should buy or otherwise enter into an investment normally incorporates a financial promotion and is subject to the restriction in the same way as other forms of promotion.

The rules do apply to sales where the CoCos would be held within SIPPs or other nominee platforms. Under COBS 2.4, a SIPP operator may rely on information in writing provided by third party firms (for example, assurances by advisers or promoters that the transaction is permitted under our rules), provided the SIPP operator can show it is reasonable to rely on that information. As explained in COBS 2.4.8G, it will generally be reasonable for a firm to rely on information provided to it in writing by an unconnected authorised person or a professional firm, unless it is aware or ought reasonably to be aware of any fact that would give reasonable grounds to question the accuracy of that information.

Promotions of CoCos to firms operating discretionary investment services are not affected, as the recipient would be a professional or eligible counterparty client. Promotions of discretionary investment services that include the possibility of investment in CoCos are not affected by our rules. We have updated existing guidance in COBS 9 to the effect that firms running discretionary investment services should exercise particular care when including a CoCo in the portfolio of a client to whom they could not promote the security under our rules.

The rules only apply to promotions or sales to retail clients. They do not apply to sales to retail clients who have elected to be treated as professional clients, provided the requirements of re-categorisation are met (see COBS 3). Our restrictions on the retail distribution of CoCos do apply to firms dealing with professional clients who opt to be treated as retail clients.

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?

- 2.10** We asked whether there are other securities that carry similar risks that should be considered in a similar light as the CoCos subject to the consultation. We received 11 responses to this question.
- 2.11** Four respondents said that other similar instruments presenting the same risks, but that are issued either by non-EEA banks or by insurers, should have similar controls. One of these respondents added that there is no reason that the jurisdiction in which the issuer is located would make any difference to the nature of the risks that we identified.
- 2.12** Another respondent said that control should be placed over CoCos issued outside the EEA where regulation is less strict. They felt that there are sufficient controls over insurers within the EEA.
- 2.13** Four respondents did not think that other instruments presenting the same risks should face similar controls. One of them, although agreeing that retail investors' exposure to complex products should be limited, said we should focus on reminding UK issuers to follow existing rules related to the sale of securities to retail investors. Similarly, an investor suggested that retail distribution of these instruments should not be considered as inappropriate as long as suitable risk warnings are given.
- 2.14** One industry representative suggested that securities that share characteristics with, or are similar in nature to, the instruments caught by our rules might also be unsuitable for ordinary retail investors, but firms are already considering their obligations under MiFID and our principles. This respondent did not think it is necessary to extend the scope of the rules and suggested that any problems with mis-sales could be dealt with through enforcement of the appropriateness and suitability rules.

Our response

We note that, even if issued by non-EEA institutions, CoCos sold to retail clients in the UK that meet the requirements in the CRR are already within scope of our rules. The potential extension we discussed in the consultation paper would be to cover any instruments that do not meet CRR criteria, for example, in relation to characteristics in respect of which the CRD IV / CRR took a different approach from Basel III.

At this time, however, we are not proposing any changes to extend the scope of the CoCo restriction to cover other instruments. We will keep this under review.

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

- 2.15** Where firms sell, promote or intermediate CoCo transactions in the retail market, we proposed that firms must make a record of the basis for the activity, including any signed statement from the investor. We asked if respondents agreed with this proposal and received 11 responses.
- 2.16** While most respondents supported the general approach – subject to suggested improvements – three disagreed with the proposal.
- 2.17** One industry respondent said that the rules may not necessarily confirm that the firm has embedded all the necessary steps and controls. This respondent suggested that it might be more beneficial to encourage firms to ensure the CoCo requirements are embedded into the sales process, including procedures, staff training and client records. This respondent also said that, if the process of identifying CoCos were easier, firms would much more easily be able to implement trading restrictions or automated controls.
- 2.18** One respondent said that we should rely on the general record keeping requirements in SYSC 9 and COBS 4.11, rather than introducing specific requirements.
- 2.19** One industry representative agreed with the general principle subject to the following considerations:
- The rules appear unduly burdensome for larger firms, such as those that lead manage new issues of CoCos and trade securities in the secondary market, but do not deal directly with retail investors. The requirements appear better suited to small firms that promote and sell securities directly to retail investors. Large firms will be interacting with financial intermediaries rather than retail clients directly. It would be unworkable to prepare a record in respect of every communication made by such firms.
 - In addition, the respondent felt that it is too difficult for a UK lead manager of a primary issue of CoCos to make records of promotions by third-party distributors, particularly where based overseas. They suggested that a more proportionate approach would be to require firms to keep records in relation to the steps they take to satisfy themselves that each distributor to whom they promote relevant securities is aware of, and will act in a manner that is compliant with, the rules.

Our response

We have not changed our record-keeping rules. However, the permanent rules will only apply to firms dealing directly with retail clients (in that they apply only to sales and to the approval or communication of promotions), not to other firms higher up in the chain of distribution. This should address the main concerns raised by firms in respect of the record-keeping requirements.

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

- 2.20** We proposed that the compliance department must also check that the sale, promotion or other intermediation activity complies with the rules restricting retail distribution of CoCos. We received 11 responses to this, four of which disagreed.
- 2.21** Two said that the proposal might entail a shift of responsibility to compliance from other departments within firms. These respondents consider that the compliance department will already be heavily involved in ensuring that there are systems and controls in place to comply with the rules. 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. Applying new responsibilities to the compliance department may remove responsibility from sales teams, and compromise the independence of the compliance department.
- 2.22** It was also suggested that transferring responsibility for compliance and, by extension, conduct to the compliance department will 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.
- 2.23** As an alternative solution, it was suggested that we build on the high-level principle (in SYSC 3.1.1R), which states that a firm should take reasonable care to establish and maintain such systems and controls as are appropriate to its business. We could require firms to have a policy in place for complying with the rules. As with other compliance policies, this would be subject to periodic review under SYSC 3.1.2G(2).
- 2.24** One respondent said that it might be disproportionate for the compliance department to check the compliance of every sale. This respondent suggested that there should be robust systems to deliver compliance, and these should be tested, for instance by checking a sample of sales.

Our response

We remain of the view that overall responsibility for the confirmation of compliance should remain with the person responsible for compliance, and have kept this requirement in the permanent rules. However, the person responsible for compliance may delegate this responsibility to an employee who reports to and is supervised by them.

In the same way a compliance officer may check the suitability of advice given by an adviser, this is an independent verification that other departments are meeting FCA rules. This aligns with the SYSC requirements flagged by one respondent.

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?*

- 2.25** We proposed to allow the person responsible for compliance function oversight in a firm to delegate their responsibility to check each case but, if they do, we proposed that they must review the approval process on at least an annual basis. Ten respondents provided feedback on this proposal.

- 2.26** Two respondents agreed with our proposals in full and others agreed with the aim of the proposal, but not entirely with the way in which they understood it to be delivered in the rules. One, for example, said that an annual review of the approval process is only appropriate where there is ongoing issuance. Where a firm has made one CoCo issue and then no further issues for several years, an annual review is superfluous. Another said that it would be prudent for the person responsible for compliance oversight function in the firm to review the approval process for compliance confirmation in line with the firm's risk-based monitoring programme as and when required.
- 2.27** One respondent agreed that the process should be reviewed by compliance on a regular basis, but said the person holding the compliance function should be able to delegate this to an appropriately qualified person in their department, acting under their supervision, rather than performing the review personally.
- 2.28** One respondent said there is no need to require a specific annual review. They felt that 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.
- 2.29** One industry respondent was concerned about the possibility of these proposals being extended to other types of investment in the future, because placing such requirements on the person responsible for the compliance function could become onerous, and detract from their ability to oversee the firm's activities as a whole.
- 2.30** Four respondents did not agree with our proposal. One suggested that it would become a tick-box process delivering little value. One of them suggested that the business function will have the primary responsibility for ensuring that sales processes are performed in compliance with appropriate rules and regulations, but with advice and independent monitoring by the compliance function.

Our response

It may be useful to clarify that there is no stand-alone requirement under the rules for a regular review of the compliance process. The requirement we proposed was that delegation of compliance checks would be subject to the process of certification of compliance having been reviewed no more than 12 months before the transaction being checked. Where there are no transactions in need of certification, there is no need for annual checks of the certification process.

We consider that the requirement for regular reviews is appropriate given the risk that delegated compliance checks could, over time, fail to adequately address compliance risks, either through changed practices or through changed circumstances, and have retained it in our final rules.

We have no plans at present to extend these specific compliance check requirements to any other products. If this changes at any time, we will consider again the burden being placed on compliance departments.

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

- 2.31** We proposed to apply the same requirements to investment funds that invest wholly or predominantly in CoCos and that are not retail-oriented regulated funds. CoCo funds within scope of the proposed rules could be structured as unregulated collective investment schemes, qualified investor schemes or as special purpose vehicles. In relation to sales that are not transacted as MiFID or equivalent third country business, the proposed rules operate as a sales restriction for non-mainstream pooled investments which are CoCo funds.
- 2.32** 11 respondents commented on this proposal. Four agreed with it, though one said that they think we overstated the risks for pooled investments in CoCos.
- 2.33** Five respondents disagreed with the proposal. Two of these respondents suggested that, where qualified fund management professionals are making investment decisions, the choice of underlying investments should be made by such professionals in accordance with the risk appetite of the target audience.
- 2.34** One respondent asked for more information on how the CoCo fund restriction works with the indirect investment exemption for CoCos, which seems to allow retail investment in funds that invest in CoCos. They said it would also be helpful to have confirmation that the restrictions apply to the promotion of securities issued by a CoCo fund and not promotion of CoCos to a CoCo fund.

Our response

We remain of the view that CoCo funds present unusual risks that create similar scope for inappropriate retail investment as direct investment in CoCos. We consider that investment in a fund that invests wholly or predominantly in CoCos, while offering the potential for some diversification among issuers, still presents serious evaluative challenges for retail investors, including unusual market contagion risks which have not yet been tested by the market.

The restriction does not apply to retail-oriented regulated funds, such as UCITS, and will not apply to any other fund holding a relatively minor (i.e. non-predominant) CoCos element within their investment pot.

We do not consider that funds heavily exposed to CoCos are likely to be suitable for ordinary retail investors. They will, however, still be available to high net worth and sophisticated retail investors as well as institutional investors.

We confirm that the restrictions apply to promotion or sales of securities issued by a CoCo fund and not promotion or sales of CoCos to the fund manager of a CoCo fund.

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?*

- 2.35** Given the risks identified, we consider that the only investors capable of being fairly assessed as sophisticated for these instruments would be those with extensive investment experience. We consulted on the introduction of Handbook guidance about the level of investment experience and understanding expected of an investor who is sophisticated in relation to these instruments. Nine respondents provided feedback on the standards we should expect.

- 2.36** Four of the respondents who have invested in CoCos already reiterated earlier comments that distribution of CoCos should not be restricted in the retail market and that in their view there is no need to conduct a client classification exercise. Two more suggested that they would not meet the criteria in the proposed guidance and that they consider this to place unfair restrictions on their ability to invest. Another respondent added that the proposed guidance restricts investors from buying securities that may convert into common equity while allowing them to buy common equity without restriction; they feel this is contradictory.
- 2.37** Two respondents expressed concern that the guidance may appear to place obligations on issuers and lead managers to assess suitability or appropriateness.
- 2.38** A respondent suggested that, on one reading, the number of retail investors who meet the guidance criteria would be extremely small and that it may be impossible for lead managers to be reasonably satisfied that the end sales would only be made to clients within scope of the sophisticated investor exemption. This in turn may lead FCA-regulated firms to stop promoting and selling CoCos to private banks and other financial intermediaries in the primary market and to cease trading with them in the secondary market, which could have a knock-on impact on liquidity. This respondent suggested that no guidance should be provided on the criteria by which to assess sophistication. They also asked us to confirm if the statements in paragraphs 2.18 and 2.39 of the consultation paper, which also discussed our thoughts on investor sophistication, are intended to apply only to determinations of suitability or appropriateness.

Our response

We remain of the opinion that these instruments are generally not suited to the needs of ordinary retail investors. They are far more complex instruments than ordinary shares. In relation to CoCos which are convertible into shares, the timing, effect on pricing, currency exchange rate (where applicable) and conversion rate into shares are only some of risk factors that are challenging for investors to model and price.

We are concerned that a number of respondents who hold CoCos already told us that they rely on their CoCos for the majority of their retirement income needs. We suggest they should consider the impact on their retirement planning if the securitatives were converted or written down.

We have amended the wording of the new guidance on assessing investors as 'sophisticated' in light of feedback. We still expect retail investors classified as sophisticated to have sufficient understanding of the instruments, but have amended the guidance slightly to remove any suggestion that, say, only individuals with experience in senior management of credit institutions would be sufficiently sophisticated, as this was not our intention.

As requested, we confirm that:

- paragraph 2.18 of the consultation paper relates to the determination of suitability and appropriateness
- paragraph 2.39 of the consultation paper discussed the Handbook guidance on which we consulted

3.

Distribution requirements for mutual society shares

- 3.1** In this chapter we summarise the responses to our proposed rules about the retail distribution of mutual society shares, and the final rules we are making.

Q8: *Do you believe we should subject all mutual society shares to the same distribution restrictions as CoCos or do you consider there is a need to allow the wider retail distribution of mutual society shares?*

- 3.2** We proposed new requirements for the distribution of mutual society shares. These requirements are less restrictive than for CoCos and allow distribution to ordinary retail investors, subject to certain safeguards. We asked respondents whether they thought that we should instead apply the same distribution restrictions as those on which we consulted for CoCos. We received 17 responses to the question.
- 3.3** Two respondents including the Financial Services Consumer Panel, said mutual society shares should be subject to the same rules as CoCos. They said that there is a risk that issuers might put their own interests first when raising capital, which can conflict with investor interests. The Consumer Panel expressed a concern that many potential purchasers are likely to be inexperienced in investing and to base decisions on trust in the mutual brand. They suggested that our proposals place disproportionate risk on retail investors.
- 3.4** Six respondents said mutual society shares should not be subject to the same rules as CoCos. They suggested there are similarities between non-readily realisable securities sold via crowdfunding platforms and this market, and suggested the two sets of rules should be more closely aligned – in particular, that the ordinary retail investors should be asked to commit to limit investment not to 5% but 10% as in the crowdfunding rules in COBS 4.7. One respondent said, where a CCDS is not listed, it would appear also to fall within the definition of a non-readily realisable security and suggested that CCDS should be subject only to the rules for mutual society shares.
- 3.5** Some industry respondents suggested that the risk of inappropriate investment by consumers who did not appreciate the nature and risk of these securities were overstated in the paper. One respondent also suggested that the main motivation to invest in mutual society shares may be for social reasons associated with the goals of the society, with monetary return a less important factor.
- 3.6** We were also asked to consider the main aims of the Mutuals' Deferred Shares Bill. The Bill aims to enable mutual societies to raise capital through the issue of deferred shares, including to their members. These respondents noted that the vast majority of mutual society members

will be ordinary retail customers and any requirements we introduce to protect them should not make it impossible for mutual societies to raise capital from their members.

- 3.7** One respondent suggested that, since the proposals were first signalled in 2013, firms should be able to follow the new rules as soon as possible. One said that, for less complex mutual society shares, we should allow wider distribution without the new requirements on which we consulted. Another suggested that there should be a general prohibition on selling mutual society shares through branch operations.
- 3.8** A few respondents argued that mutual society shares present similar risks to ordinary equity and therefore should not be subject to any additional distribution requirements. One argued that ESMA only warned investors about the risks of CoCos and nothing was said about the risks of inappropriate distribution of mutual society shares, so we were going further than ESMA.
- 3.9** One respondent felt that the proposed rules would reduce the ability of mutual societies to raise capital, increase the cost of raising capital and reduce the market demand and liquidity for mutual society shares, leading to an increase in the risks for those retail investors who do choose to hold such instruments.
- 3.10** Another respondent suggested that there is a case for inexperienced retail investors to be protected from certain products, but extending the CoCos approach to mutual society shares would be excessive. Instead, they suggested that we should request institutions to be more transparent about their dividend policy.

Our response

We remain of the opinion that mutual society shares should be treated differently in our rules to CoCos, in recognition that the instruments seen so far have tended to be less complex than CoCos and that mutual societies have limited avenues for raising capital. We have therefore made rules imposing lighter requirements relative to the restrictions applicable to the retail distribution of CoCos.

We do not however agree with arguments that mutual society share distribution should not be subject to additional requirements relative to other equity instruments. Distribution of similar loss-absorbing securities to mutual society customers has led to widespread consumer detriment in other jurisdictions. Inappropriate investment by inexperienced savers could also undermine the loss-absorbency role these securities are intended to play in issuers' capital structures. We believe the rules being introduced provide the right mitigation of those risks. The rules introduce additional requirements for firms selling or promoting the securities; they do not prohibit the sale or promotion of the securities.

This approach should still allow mutual societies to raise capital through the issue of shares. We believe that the requirements we are introducing are compatible with the aims of the Mutuals' Deferred Shares Bill. We will continue to monitor legislative and market developments. If our current rules do not cover the full range of shares mutual societies are permitted to issue, and we have similar concerns in relation to distribution to ordinary retail investors, we will consider changes to our rules.

Having considered feedback to the consultation, we have decided to adopt the same notional concentration / exposure limit for the warnings and investment undertaking 'cap' requirements on mutual society shares as adopted for rules on the direct offer promotion of non-readily realisable securities, that is, 10% as opposed to the 5% in the draft rules we consulted on. We have amended the non-readily realisable security definition to clarify that unlisted mutual society shares are subject only to the rules being introduced in this paper.

We have also decided to bring forward the implementation date of the rules on mutual society shares as we have received indications from industry representatives that early implementation would be helpful to firms looking to issue these instruments. The rules on mutual society shares will come into effect on 1 July 2015.

The Joint Committee of the European Supervisory Authorities published a reminder to financial institutions about the applicable regulatory requirements when financial institutions sell to their own client base financial instruments that they themselves have issued.¹⁰ The statement noted that recent regulatory and market developments have increased the risks of consumer detriment arising from this practice. The statement called on firms to take steps to address this risk. We consider our rules to be aligned with the views of the European Supervisory Authorities.

We are not prohibiting the sale of mutual society shares through branch operations. Such sales will be subject to the requirements we are introducing in the same way as sales through any other distribution channel.

Q9: *Alternatively, do you believe that applying to CoCos the same approach as proposed for mutual society shares would achieve an appropriate degree of consumer protection?*

- 3.11** We asked if CoCos should be treated in the same way as we proposed for mutual society shares; we received nine responses.
- 3.12** Four respondents suggested that the rules should allow distribution of both mutual society shares and CoCos to ordinary retail investors without restriction or additional requirements. Four respondents suggested that the proposed requirements for mutual society shares should not be applied for CoCos since they pose different risks for investors. On the other hand, one respondent suggested that the same regime should apply to the distribution of CoCos.
- 3.13** One respondent called for the CoCo and mutual society share definitions to be clarified to avoid confusion.

¹⁰ European Supervisory Authorities, *Placement of financial instruments with depositors, retail investors and policyholders ('self-placement')*, 31 March 2014: www.esma.europa.eu/content/Placement-financial-instruments-depositors-retail-investors-and-policy-holders-Self-placemen

Our response

We are proceeding with the approach on which we consulted, restricting the promotion and sale of CoCos and adding requirements for the sale of mutual society shares. We see rational grounds for treating the instruments differently.

Q10: Do you believe secondary market transactions should be subject to the same rules as primary market sales?

- 3.14** We proposed only to apply rules to sales in the primary market, where we see the greatest risk of inappropriate distribution. We asked if respondents agreed with this approach and received 14 responses.
- 3.15** Eight respondents suggested that the requirements on the sale of mutual society shares should not apply to sales in the secondary markets. One suggested that we allow firms to apply the same requirements to sales in the secondary markets on a voluntarily basis. One industry respondent said that, if we see problems in the secondary markets in future, we could consider extending the rules to sales in such markets at that point. One suggested firms would face practical challenges if we were to apply implement similar restrictions in the secondary market since issuers generally have no control over the secondary trading of their securities.
- 3.16** On the other hand, two respondents said that, as our intention is to protect ordinary retail investors, it is logical to apply similar requirements to secondary market transactions. One respondent suggested that the likely low trading volumes should mean that the costs would not be disproportionate if we applied the rules to secondary trading but, at the same time, the low trading volumes make it unnecessary to do so in their view.

Our response

At this stage, we are only applying the requirements in relation to sales on the primary market. We will continue to monitor the situation and can extend the rules at a later stage to cover secondary markets, if necessary. If firms wish to apply the same approach to secondary markets of their own volition, they are free to do so.

Q11: Do you agree with the proposed basis on which mutual society shares could be distributed in the retail market?

- 3.17** The proposed rules permit distribution of mutual society shares to professional and eligible counterparty clients without any additional requirements. They would also permit distribution to retail investors classed as certified sophisticated investors¹¹, self-certified sophisticated investors¹² and certified high net worth investors.¹³ For other clients (i.e. ordinary retail clients)

¹¹ These are retail clients with extensive investment experience and knowledge, who are better able to understand the risks of complex and unusual investments.

¹² To self-certify as sophisticated, a client must, among other factors, meet one of four criteria demonstrating their investment experience.

¹³ Among the criteria such clients must meet are having an annual income of more than £100,000 or having investable net assets of more than £250,000. Net investable assets exclude the value of the client's home, pension funds and any benefits under insurance policies. Any debt the client owes should be subtracted from the value of assets held by the investor.

in the EEA, our proposed rules would permit distribution where the firm provides specific risk warnings.

3.18 In addition, for non-advised sales that are not MiFID or equivalent third country business, firms would be required to (1) obtain from the ordinary retail client an undertaking to limit their investment in mutual society shares to 5% of their net investable assets, and (2) assess appropriateness and warn the client if he or she has insufficient knowledge and experience, complying with the requirements in COBS 10 as though the firm was providing non-advised investment services in the course of MiFID or equivalent third country business.

3.19 We received 13 responses to the question we posed about these proposals. While most respondents supported the general approach, five disagreed with the proposed requirements. The following points were raised:

- one of these respondents, an existing CoCo investor, considered that proper enforcement of contractual obligations would provide sufficient protection for consumers
- one said the proposals are too restrictive and that having in place proper disclosure requirements should allow investors to make well-informed decisions
- another noted that it would be impossible to verify the percentages of capital invested in these instruments for ordinary retail investors
- one industry respondent reiterated their view that CoCos and mutual society shares should be subject to no more constraints on distribution than ordinary shares

3.20 Of those respondents who agreed with the general approach, some suggested modifications to our proposals.

- Most industry respondents that provided feedback to this question did not agree with the proposed investment 'cap' of 5% of an ordinary retail investor's net investable assets for non-advised sales that are not MiFID or equivalent third country business. As summarised in Question 8, they suggested that the limit should be aligned with the approach for non-readily realisable securities, where the 'cap' is 10%. One respondent suggested that introducing the existence of a cap could confuse the marketplace, as this rule does not apply to investment in CoCos.
- One of the respondents said it is important that the rules cater for electronic means of fulfilment, including electronic signatures where appropriate.
- One respondent asked for clarification on whether the rules are intended to apply to a SIPP operator receiving an instruction from a client or their adviser to buy one of these instruments for the client's SIPP.
- In relation to the proposed risk warning, one industry respondent argued that we do not prescribe wording for other investments, so firms should be free to determine the exact wording. This respondent claimed that the prescribed wording was not warranted by the level of risk posed by the instruments and suggested that the use of the word 'share' could confuse building society members.
- One respondent suggested that it would be helpful to have guidance on how firms might assess the experience and knowledge required to understand the risks involved in mutual society shares.

- One of the respondents added that they expect us to carry out a thorough review of the rules to take account of Solvency II and the needs of mutual insurers and friendly societies.

Our response

The starting position for all sales of mutual society shares to ordinary retail clients is that the firm must provide the prescribed risk warnings required under our new rules, in addition to complying with other regulatory requirements, including but not limited to those relating to offer documents and financial promotions. We have considered the suggestion made by one respondent that firms should be able to convey the risk warnings in their own words, but consider that there is little to be gained from such flexibility, while there is significant scope for diluting the effect of the risk warnings that we want consumers to receive. We have therefore retained the prescriptive nature of this requirement in the finalised rules.

We consider that relying solely on risk warnings will not provide sufficient investor protection where ordinary retail clients are not receiving advice and MiFID rules do not apply, so we have decided to retain the additional requirements for such sales.

In relation to non-advised sales where no MiFID investment service is provided, we have raised the suggested investment 'cap' for ordinary retail investors from 5% to 10% to bring this into line with the similar 'cap' applicable in the rules for direct offer promotion of non-readily realisable securities (see COBS 4.7). We do not consider the context of distribution and risks to consumers to be exactly the same, but we accept that the lower figure for mutual society shares could be misunderstood as representing an assessment of the relative investment risks of these securities, which is not the case. Both 5% and 10% in our view represent reasonable notional figures for concentration risk that should help limit the scope for unaffordable losses, a particular risk for investors who are neither sophisticated nor wealthy.

The investment 'cap' should not be taken as meaning that we consider that investing 10% of an ordinary retail investor's money in mutual society shares is suitable for all consumers, or indeed that 10% of assets is the 'correct' investment amount for any given investor. Suitability can only be determined with reference to the individual investor's knowledge, circumstances and objectives, and different amounts may be suitable depending on individual circumstances. Indeed, for some consumers any level of investment in mutual society shares will be unsuitable.

We are not proposing that firms take responsibility to assess whether or not clients make good on the commitment not to invest more than 10% of their net investable assets. The 'cap' for non-advised, non-MiFID sales relies on self-certification by the client.

As signalled in our response to Question 2, we will keep the market and regulatory developments under review and, if market developments following the introduction of Solvency II lead to similar concerns, we will consider introducing similar rules for securities issued by mutual society insurers.

As we noted in CP14/23, there is nothing in these rules that prevents these requirements from being fulfilled via electronic means, for instance, via the use of electronic signatures where appropriate. We have now added new guidance to provide greater clarity for firms on this point.

We do not believe it is necessary to introduce Handbook guidance for firms when assessing investors as sophisticated for these securities. As a starting position, however, we note that investors who lack experience with direct shareholdings are unlikely to possess the requisite knowledge to adequately understand the risks involved.

The rules on mutual society shares only apply where there is a direct sale to a retail client. Where the transaction is between the issuer or some other firm on one side and a nominee on the other, the requirements do not apply. We may revisit this if firms are found to be using SIPP sales to circumvent the consumer protections provided by these rules.

Q12: Do you agree with our proposal to require firms to conduct an appropriateness test in relation to non-advised sales of mutual society shares to ordinary retail investors even if they are not carrying on MiFID or equivalent third country business?

- 3.21** Under the MiFID appropriateness test, firms arranging certain transactions on a non-advised basis must check if the investor has sufficient knowledge or experience to understand the risks involved. As a further safeguard, we proposed to apply the test to non-MiFID, non-advised sales of mutual society shares. 13 respondents provided feedback on this proposal.
- 3.22** Six respondents agreed with the proposal. Two of these respondents said that the appropriateness test should be carried out irrespective of whether or not firms are carrying on MiFID business, unless this function is outsourced to a broker conducting MiFID business on behalf of the firm.
- 3.23** Five respondents did not agree with the proposal. One suggested that it should not be up to a third party, or indeed the regulator, to assess whether investments are appropriate for an individual unless that individual is seeking advice. Another said that there is no way of confirming the accuracy of data supplied by investors, and individuals will consider it an invasion of privacy.
- 3.24** Two respondents noted that, in addition to the appropriateness test, the customer will also receive a risk warning and be required to sign a statement acknowledging the risks. They said there is no need to apply all three measures to the same transaction.
- 3.25** One respondent argued that, because this is a new market, investors will undoubtedly 'fail' an appropriateness test, which would result in them being told the shares are inappropriate investments. This could hamper the aim of the Mutuals' Deferred Shares Bill by making it almost impossible to sell shares to mutual society members.
- 3.26** One respondent suggested that the treatment of mutual society shares should depend on the level of complexity, risk profile and liquidity in the underlying instrument.

Our response

We have decided to require firms to carry out the appropriateness test for non-advised sales that do not amount to investment services provided in the course of MiFID or equivalent third country business. Firms within scope of MiFID are already required to calculate this test.

The risk warning, statement and appropriateness test work together by drawing important risks to the attention of ordinary retail investors and, where no advice is given, checking that the prospective investor is sufficiently knowledgeable to understand the risks of the financial instrument, warning them if this is not the case and, if the sale goes ahead, asking the investor to limit their exposure to these securities. We consider that the appropriateness test is likely to offer a valuable protection to inexperienced investors passively receiving offers of these securities, and who may comprise a significant proportion of mutual society members.

While titled 'the appropriateness test', the assessment required (as set out in COBS 10) is whether the investor has the experience and knowledge to understand the risks involved. It is already required in relation to many mutual society shares where non-advised sales are within MiFID scope.

If an investor is unable to demonstrate that they have sufficient experience or knowledge to understand the risks, the firm must decide whether to allow the sale to proceed. One option where the prospective investor fails the appropriateness test may be that the firm is able to provide additional information to the investor to raise their knowledge.

As set out in COBS 10.2.4R, a firm is entitled to rely on the information provided by a client unless it is aware that the information is manifestly out of date, inaccurate or incomplete. COBS 10.3.2R(1) addresses situations where the client chooses not to provide the information to enable the firm to assess appropriateness, or if they provide insufficient information regarding their knowledge and experience. In such cases, the firm must warn the client that such a decision will not allow the firm to determine whether the service or product envisaged is appropriate for them.

Q13: *Do you agree with our proposal to require records to be kept for each sale of mutual society shares to retail clients?*

- 3.27** Of the 11 responses we received to this question, eight agreed with our proposal to require records to be kept for each sale. One of these respondents added that records of each sale should be kept for as long as the shares are held by the client.
- 3.28** The other respondents did not agree with the proposals. One felt that the standard record keeping requirements should apply, rather than specific rules for these instruments.

Our response

We have retained the requirement that firms must keep a record for each transaction. We consider this a reasonable and proportionate requirement to enable effective supervision of compliance with these rules.

Q14: Do you agree with our proposal to require the compliance department to confirm the compliance of each mutual society share sale?

3.29 11 respondents disagreed with our proposal to require the compliance department to confirm compliance with our rules for each mutual society share sale.

- A few noted that the business function, rather than compliance department, has the primary responsibility for ensuring that sales processes are performed in compliance with appropriate rules and regulations. It was suggested that requiring compliance oversight of the process gives an impression that the compliance function will also be underwriting the risks run by the business function. These respondents also expressed the view that 'signing off' on a client-by-client basis is a front-office function and inconsistent with the requirement that the compliance area is functionally independent from a firm's business activities.
- One respondent said that the proposal does not seem consistent with the MiFID requirement that the 'relevant persons involved in the compliance function must not be involved in the performance of services or activities they monitor'.¹⁴
- One respondent said that a stand-alone file of information on sale approval and statistics may not necessarily confirm the firm has embedded all the necessary steps and controls.

3.30 Two respondents agreed with the proposal.

3.31 One industry respondent agreed that it is appropriate to maintain electronic records for each sale but that a manual check by the compliance department of each sale would be unduly onerous if appropriate risk-based measures have been put in place.

Our response

As for CoCos, responsibility for confirmation of compliance will remain in the compliance department to ensure independent oversight of the sales process for mutual society shares. We refer to our response to Question 4 for additional information on what we expect from firms in relation to internal assignment of responsibilities. Nothing in the rules prevents the compliance checks from being performed through appropriate electronic means.

Q15: 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?

¹⁴ Article 6(3)(c) of the Implementing Directive

- 3.32** Six respondents agreed with our proposal that the person responsible for compliance oversight function in the firm must review the process for compliance certification on at least an annual basis.
- Two of these respondents noted that review of the approval process is sensible but, as issuance of securities may not be regular, a simple nil return should be possible in years when no sales have been made. They said it is more important for systems and processes to be reviewed before a further issue if there has been a lapse of time since the previous issue, or annually if they are offered on an open basis.
 - One respondent added that the person responsible for compliance oversight should be able to delegate this responsibility to an appropriately qualified person in their department, acting under their supervision, rather than performing the review personally.
- 3.33** Six respondents did not agree with our proposal. One noted that the business function will have the primary responsibility for ensuring that sales processes are performed in compliance with appropriate rules and regulations.
- 3.34** One respondent agreed that the compliance department should be responsible for reviewing the procedure, and for monitoring its effectiveness, as well as the firm's adherence to it, but this respondent did not think that it is appropriate for the compliance department to be an integral part of the transaction as is proposed.

Our response

Firms selling mutual society shares to retail clients must have a process in place to ensure distribution complies with our rules. Our rules do not require stand-alone reviews of the certification process in the absence of transactions in need of certification. They only require that the process used to certify a transaction must have been reviewed by the compliance oversight function within the previous 12-month period. As with the equivalent requirement for CoCos (see the response to Question 5), we consider that regular reviews of the process for certifying transactions is appropriate given the risk that delegated compliance checks could, over time, fail to adequately address compliance risks, either through changed practices or through changed circumstances.

4.

Existing investors, market information and cost benefit analysis

- 4.1** The consultation paper discussed the impact of our proposals on existing investors, provided a summary of the market affected by our proposals, and summarised our analysis of market failures and the costs and benefits of our proposed rules. This chapter summarises the feedback received on these points.

Q16: Do you have any comments on the impact of our proposals on existing investors?

- 4.2** We asked for feedback on the expected impact of our proposals on investors who already hold CoCos or mutual society shares. We received 28 responses.
- 4.3** Four respondents suggested that the restrictions on CoCos, while focused on future distribution, will lead to reduced market liquidity and this, in turn, will affect retail investors. This will particularly be the case if firms go beyond the requirements and only allow retail clients to trade existing holdings if they meet the requirements to be high net worth or sophisticated. Two respondents suggested that the restrictions are likely to lead to a change in the market make-up over time, with greater focus on institutional investors and less on retail investors.
- 4.4** One investor said that he would like to keep the CoCos he already holds. Another suggested that the rules should only apply to new issues, rather than to those that are already in the market.
- 4.5** An industry respondent expressed the view that the proposals in relation to existing investors in mutual society shares are reasonable and they do not foresee any problems in this part of the market.
- 4.6** An industry respondent noted that the publication of the proposals for CoCos prompted a re-assessment by a number of intermediaries and institutional investors of the securities. However, this respondent did not think that the proposals caused any fundamental change in the distribution of CoCos, which have been almost exclusively sold to institutional investors in recent years.
- 4.7** 18 of the responses were from investors with existing holdings in the CoCos issued by one firm.
- These respondents thought the restrictions on sales to ordinary retail investors would have an impact on existing investors by reducing liquidity. Some also suggested stockbrokers are refusing to deal with existing retail investors as a result of the introduction of the temporary rules.

- Some of the investors who responded to the consultation suggested they have half or more of their retirement funds in these securities and wrongly thought that they would be obliged by the rules to sell the securities and lose the high yields that have been paid to date.

Our response

The rules do not require existing ordinary retail investors to sell their existing holdings and do not impose any additional requirements or restriction on firms in relation to advice or transactions relating to the sale of retail clients' existing investments in CoCos. The rules only prevent new sales or promotions of CoCos or interests in CoCos (or CoCo funds) to ordinary retail investors.

The possibility of reduced liquidity in the future, particularly for existing retail investors, was considered in the consultation paper. The cost-benefit analysis in Annex 1 noted that *'there may be a reduction in liquidity for CoCos and/or mutual society shares. We do not regard this as a significant risk, however, as CoCos are primarily institutional market investments (at least in the UK). The largest building societies are also able to raise capital from institutional markets. Unlisted mutual society shares are likely to be fairly illiquid at the best of times, and on the whole we expect the net impact of our proposals on mutual society shares to be to facilitate capital-raising efforts by smaller societies compared to the current position.'* We were concerned about investors' reports that they were having difficulties disposing of their CoCos, which they believed to be a result of the temporary rules introduced last October. We sought information from firms active in this market. The overall feedback we received supports the analysis set out in our consultation paper (as reproduced above).

One industry respondent told us that they have not seen evidence to date that liquidity has been reduced for disposals of retail-sized positions. Liquidity issues may also arise for other reasons, including market sentiment. Brokers may still act for retail investors who wish to sell out of a current holding. In time the market may evolve to focus on institutional investment, which may make it harder for retail investors – particularly those with smaller sums invested – to sell holdings. We consider that this risk is unlikely to outweigh the benefits of preventing harm to new ordinary retail investors who should not be exposed to the instruments in the future.

Investors with a large proportion of their pension savings invested in CoCos should carefully consider their position. These are generally risky instruments and investors could lose not only income but potentially all of their capital if the issuer faces financial stress or, for some types of CoCos, should contagion risks crystallise or the issuer exercise certain discretionary rights.

Q17: Do you have any comments on our analysis of the market for CoCos and mutual society shares or further information about it?

- 4.8** We summarised our understanding of the market for CoCos and mutual society shares and asked respondents if they had any further information we should take into consideration. Seven respondents commented.

4.9 Three of the responses from existing CoCo investors reiterated feedback mentioned earlier in this paper, arguing that CoCos and mutual society shares should be freely available in the retail market, that they should be simple to understand, and that limiting investment to institutional investors only will have a detrimental impact on the market.

4.10 One respondent, focusing their answer on CoCos, noted that, in a UK context, issuances are likely to focus on CoCos eligible as AT1 capital. Under the Basel III framework, all banks and building societies are expected to maintain a buffer of AT1 capital that totals 1.5% of risk weighted assets. Given total risk weighted assets of around £2,000bn in the UK, this suggests a total volume of AT1 CoCos of around £30bn in the UK and in excess of £80bn in continental Europe in the near future.

4.11 Two respondents focused their answers on the market for mutual society shares.

- One said that they expect the market for mutual shares to grow significantly in the future, particularly if legislation is approved to permit their issue by mutual insurers and friendly societies. Over a ten-year period, they said, the market could reach £2bn or more, growing at £200m each year, substantially more than was estimated in our analysis. They suggested that the size of the market will depend on the final shape of relevant legislation as well as the rules implemented by us.

With regards to the latter point, the respondent noted that we had introduced (in a separate consultation exercise) a basis by which mutual societies with a with-profits fund might benefit from a split of their existing common fund into the constituent with-profits fund and mutual capital.¹⁵ Where this happens, the amount of surplus to be recognised as mutual capital may in some cases be small, fuelling a need to explore new funding sources.

They concluded by noting that they expect mutual societies would welcome the opportunity to market mutual shares to their existing membership base, as a means of enhancing the relevance of the mutual model to members as well as enabling members to take a greater stake in the business of a society that they support.

- The other respondent commented that we should ensure that our rules apply in a consistent manner for UK and overseas mutual societies.

4.12 One respondent commented that our analysis of the market is bound to be shown to be inaccurate over time, but did not explain why this should be the case or in which way it is inaccurate.

Our response

There is no substantial difference in the estimated future market size for CoCos supplied by the respondent who offered an alternative estimate and the figures quoted in the market analysis in Annex 1 of the consultation paper.

It is difficult to estimate the future size of the mutual society share market, since the market is still in an early stage of development and there is uncertainty about how much it may grow in the future. We acknowledge that it may be larger than we signalled – to the extent predicted in the feedback we received,

¹⁵ *Mutuality and with-profits funds: a way forward*, PS14/5, March 2014, www.fca.org.uk/static/documents/policy-statements/ps14-05.pdf

or by an even greater degree. Our cost-benefit analysis is scale-able and, therefore, if the market does grow by more than we estimated, the benefits of our proposals should still outweigh the costs.

The rules we are introducing apply consistently to shares issued by UK and overseas mutual societies.

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?

- 4.13** The consultation paper included an analysis of the costs and benefits of our proposals. We asked for comments on this analysis and received nine responses.
- 4.14** Four of the investors with concerns about a particular CoCo reiterated their suggestions that the temporary rules and proposed permanent rules have caused problems for existing investors. Another respondent said there may be additional indirect costs for existing retail investors who may find that trading facilities for retail-sized investments become more limited as market focus shifts toward the needs of institutional investors.
- 4.15** One respondent is of the opinion that the cost-benefit analysis materially overstates the risks of CoCo investment because it assumes loss on conversion, which may not be realised if CoCos convert into tradable equity securities and presumes excessive correlation between the write down or conversion of one bank's securities and another. In addition, this respondent said that the analysis fails to account for the income that investors would receive by holding CoCos before any presumed conversion or write down.
- 4.16** One respondent suggested that many of the upfront costs will already have been incurred by firms in relation to CoCo distribution, when the temporary rules were introduced. They also suggested that existing regulatory obligations – including those deriving from MiFID, the FCA Principles for Businesses and guidance on the responsibilities of providers and distributors for the fair treatment of customers – should already limit inappropriate distribution of CoCos. The respondent continued with some more detailed points:
- The rules that apply to CoCos will have an impact on firms which do not have a direct relationship with retail investors, since they aim to stop firms doing 'anything that would or might result in' a retail investment in CoCos outside the exemptions in the rules. As such, the respondent suggested, the costs are likely to be higher since firms, which do not have a direct relationship with the end client, such as those that lead manage issues of CoCos, will also be subject to additional costs. These costs include, for example, conducting due diligence on counterparties, sending new documentation to clients, taking additional steps to be reasonably satisfied that intermediaries will comply with the principles, establishing processes and training staff.
 - Some of the incremental compliance costs in our analysis do not have detail on how they were estimated. Other assumed costs are not valid, e.g. because third-party distributors are likely to be large firms and the estimated hourly costs of staff time are based on old research.
 - Record keeping costs are likely to be higher than estimated.
 - The costs of making changes to literature are mentioned but not estimated.

- 4.17** With regard to the proposed rules for mutual society shares, one respondent noted that the estimated costs are likely to be scale-able, depending on business volumes. They also suggested that additional benefits may arise from the proposals in terms of creating a retail market for mutual society shares and the potential returns available to these investors. On the other hand, one respondent commented that the requirements we have proposed in relation to mutual society shares may reduce liquidity and constrain the usefulness of these instruments from a capital-raising perspective.

Our response

While some respondents believe we have overstated the risk of inappropriate investment, we consider that we are taking the right approach. These are still new and largely untested financial instruments that carry potential for significant consumer harm where sold to ordinary retail investors who cannot adequately assess and price the risks. We are acting as part of our early intervention approach that seeks to identify and address emerging risks of significant consumer detriment.

We note the following with regard to specific points made in relation to the cost-benefit analysis.

- The expected market impact of a conversion or write down by one CoCo is based on a survey of 150 investors, including those working in private banks, wealth managers, hedge funds, insurance companies and asset managers.¹⁶
- One respondent observed that we did not take account of income received by ordinary retail investors from CoCos. The relatively high rate of income of many CoCos is offered in exchange for significant risks to capital, and in our view cannot be said to, in and of itself, prevent detriment where the investor did not appreciate and/or could not afford those risks. In addition, for AT1 CoCos (which are fast becoming the predominant format), the income on offer is discretionary and at risk independently of any event of conversion or writing down of the principal amount. Triggered conversion into equity (for equity-conversion CoCos) would by definition occur at a time of financial stress for the issuer. Conversion into shares at such point would very likely result in losses for CoCo investors.
- If we assume that distributors are all large firms (instead of our previous assumption that they are medium firms) the one-off training costs increase to between £5.6m and £21m. This does not change our assessment that the benefits outweigh the costs and, as we do not expect all distributors to be large firms, this is likely to overstate the costs.
- Where specific sources of data were not cited for costs, figures are based on our experience supervising the market. No respondent provided a different estimate for these figures.

¹⁶ *The Revolver*, Macro Credit Research, 12 May 2014, RBS: <http://ftalphaville.ft.com/files/2014/05/The-Revolver-Cocos-Investors-call-for-standardisation-more-consistency-RBS.pdf>

- Where hourly costs were based on surveys from previous years, the figures were increased in line with wage inflation.
- The changes we have made to the rules should reduce costs for firms. See annex 2 for further information.
- We did not estimate the costs for changes to literature as we expect them to be minimal. Only one respondent to the consultation commented on these costs and did not supply an estimate of the incremental costs that would arise as a result of the rules on which we consulted.

The costs and benefit estimates in the consultation paper are scale-able and, if the market grows more than expected (or less), the benefits should continue to outweigh the costs, as estimated in the cost-benefit analysis.

4.18 We also received some general comments from two respondents in relation to the use of our product intervention rule-making power. They argued that we need to adopt a more consistent, risk-based approach to assessing product risks and developing consumer protection. This would ensure that products such as CoCos and mutual society shares are dealt with by our rules in a manner consistent with rules applying to other products where we have concerns. These respondents said that, to date, different approaches have been pursued for non-mainstream pooled investments, non-readily realisable securities and, now, CoCos and mutual society shares. At the same time, they said, other investments, which may carry similar investment risks, are not subject to any additional requirements.

4.19 It was also suggested that any type of investment not subject to additional distribution restrictions created by product intervention rules may come to be regarded by the industry as being generally suitable for ordinary retail investors, thereby undermining the suitability rules which apply when a firm makes a personal recommendation.

Our response

We have taken note of this feedback and will consider it as we go forward. The comments may be particularly relevant to some forthcoming initiatives.

- The recast MiFID directive will take effect in 2017 and will introduce product governance requirements.¹⁷ Under these, product providers will need to consider the needs of consumers in the target market and reflect those needs in the design, structure and distribution strategy of their products before launch, and to monitor the product during its life to check it works as expected. Where firms meet these standards, there may be less need for us to intervene to address the risk of inappropriate distribution.

¹⁷ For more information, see ESMA's *Technical Advice to the Commission on MiFID II and MiFIR*, 19 December 2014: www.esma.europa.eu/content/Technical-Advice-Commission-MiFID-II-and-MiFIR

- The PRIIPs Regulation is likely to include requirements in relation to the disclosure of appropriate target markets and clear risk warnings to potential investors. This, combined with the MiFID II product governance requirements, may further reduce the need for added requirements or restrictions on distribution.

As we work on these initiatives we will monitor our existing interventions and will make changes if, or when, they become necessary. We will also bear in mind this feedback on the process for making product intervention rules.

It remains the responsibility of advisers to assess the suitability of investments before making a personal recommendation, having regard to the characteristics and risks of the investment and the profile of the investor, in particular their investment objectives and risk tolerance. Unsuitable advice or other failings under our rules cannot be justified or excused with reference to our non-intervention in respect of a particular product or practice. Firms are reminded that their regulatory responsibilities in respect of any given financial promotion or transaction are not exhausted by compliance with product intervention rules alone.

Our product intervention approach is and remains targeted at products and contexts posing a particular risk to our objectives.

Annex 1

List of non-confidential respondents

A Bowker

Adrian Howard-Jones

Alexis Brassey

Andrew Jones

Anthony Hoare

Association of Financial Mutuals

Association of Investment Companies

AXA Wealth

Bankers Alliance Insurance Company Limited

Barclays Bank PLC

Building Societies Association

Capita Insurance & Benefits Services

Charles Stanley & Co Limited

Chris Walden

City of London Law Society Regulatory Law Committee

Dave Hatch

David Huggins

David Quas

David Wright

Ecology Building Society

Financial Services Consumer Panel

Garth Nicolson

Giles Sandeman-Allen
HSBC Holdings Plc
International Capital Markets Association
Jane Carter
Jeremy Cutler
Jim Grassick
John Rawlinson
Jon Pocock
LV=
Mark Taber
Neal Morris
Nordic Securities Association
Offshore Structures Limited
R.R. Glavey
Rafael Joory
Richard Coe
Richard Gray
Roy England
Rupert Page
Sameena Shakoor
Stephen Tomson
Thomas Rasche
Tim Kempster
UBS AG
Virgin Money plc
Waseem Shakoor
Wealth Management Association

Annex 2

Cost-benefit analysis

1. We have considered whether the changes to the rules that we consulted on will have an impact on the cost-benefit analysis, in particular in relation to two main areas. We found that these changes are not significant enough to require an update to the cost-benefit analysis.

| Changes to the rules proposed in CP14/23 | Impact on our analysis and estimates of costs and benefits |
|---|--|
| Firms that are involved in the sale of CoCos but do not directly deal with retail investors will no longer be subject to the rules. | <p>Costs: firms that do not deal directly with retail investors will not incur the incremental compliance costs described in the original analysis. Based on the assumptions in the original analysis, we estimate that the change in rules may reduce the number of firms affected by up to 10%. Assuming all firms incur similar costs, this would reduce the total one-off incremental costs to between £4.95m and £9.45m and incremental ongoing annual costs to between £2.4m and £11.7m (or 90% of the initially estimated costs).</p> <p>Benefits: we do not expect there to be a significant impact on the estimates of benefits provided in the original analysis because distributors that deal directly with retail investors will still be subject to the rules.</p> |
| For mutual society shares, the investment 'cap' for ordinary retail investors will be 10% of net investable assets. | <p>Costs: we do not expect there to be a significant impact on costs to firms.</p> <p>Benefits: we do not expect there to be a significant impact on the estimates of benefits provided in the original analysis. As set out in this paper, this change represents a reasonable approach to dealing with concentration risk that should help limit the scope for unaffordable losses, a particular risk for investors who are neither sophisticated nor wealthy.</p> |

2. Other changes to the rules are designed to make our expectations clearer, rather than change the way in which the rules operate, so will also not affect the analysis.

Expected effect on mutual societies

3. The rules we have made recognise that:
 - mutual societies, particularly smaller societies, may have little or no access to institutional markets to raise regulatory capital
 - the concept of mutuality entails ownership by members and some consumers may genuinely wish to support mutual societies of which they are members by providing core capital, and
 - the mutual society share instruments seen so far have tended to be less complex than CoCos, so we have made rules imposing lighter requirements relative to the restrictions applicable to the retail distribution of CoCos
4. As explained in the consultation paper, we do not consider there to be a need to treat mutual society issuances of CoCos in a different manner to those issued by other institutions. We expect that only the largest mutual societies will undertake the complex and expensive exercise of issuing CoCos, and most of them will have access to institutional investors. We do not expect the restriction on CoCos to have a significantly different impact on mutual societies compared to other types of credit institution. Our rules still allow for distribution to non-retail clients, sophisticated retail clients and high net worth retail clients.

Appendix 1

Made rules (legal instrument)

**PRODUCT INTERVENTION (CONTINGENT CONVERTIBLE INSTRUMENTS
AND MUTUAL SOCIETY SHARES) INSTRUMENT 2015**

Powers exercised

- A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137A (general rule-making power);
 - (2) section 137D (product intervention rules);
 - (3) section 137R (financial promotion rules);
 - (4) section 137T (general supplementary powers); and
 - (5) section 139A (power of the FCA to give guidance).
- B. The rule-making powers listed above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force as follows:
- (1) Part 1 of Annex A and Part 1 of Annex B come into force on 1 July 2015;
 - (2) Part 2 of Annex A and Part 2 of Annex B come into force on 1 October 2015.

Amendments to the FCA Handbook

- D. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- E. The Conduct of Business sourcebook (COBS) is amended in accordance with Annex B to this instrument.

Citation

- F. This instrument may be cited as the Product Intervention (Contingent Convertible Instruments and Mutual Society Shares) Instrument 2015.

By order of the Board of the Financial Conduct Authority
4 June 2015

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless stated otherwise.

Part 1: Comes into force on 1 July 2015

Insert the following new definition in the appropriate alphabetical position. The text is not underlined.

| | |
|-----------------------------|--|
| <i>mutual society share</i> | <p>a <i>share</i> which:</p> <p>(a) meets the requirements for common equity Tier 1 capital instruments under article 28 or 29; and</p> <p>(b) is issued by an institution which is of a type listed in article 27;</p> <p>in each case of the 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.</p> |
|-----------------------------|--|

Amend the following definition as shown.

| | |
|--|---|
| <i>non-readily realisable security</i> | <p>a <i>security</i> which is not any of the following:</p> <p>...</p> <p>(c) a <i>non-mainstream pooled investment</i>;</p> <p><u>(d) a <i>mutual society share</i>.</u></p> |
|--|---|

Part 2: Comes into force on 1 October 2015

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

[*Editor's Note:* The definition of “contingent convertible instrument” replaces the definition made by the *Temporary Marketing Restriction (Contingent Convertible Securities) Instrument 2014 (FCA 2014/47)* which expires on 1 October 2015.]

CoCo fund

an *unregulated collective investment scheme, qualified investor scheme* or a *special purpose vehicle* under which the investment returns received by the investor, or the scheme or vehicle's ability to fulfil any payment obligations to the investor, are wholly or predominantly linked to, contingent on, highly sensitive to or dependent on, the performance of or changes in the value of *contingent convertible instruments*.

contingent convertible instrument

a *financial instrument* which meets the requirements for either:

- (a) Additional Tier 1 instruments under article 52; or
- (b) Tier 2 instruments under article 63, provided:
 - (i) the provisions governing the instrument require that, upon the occurrence of a trigger event, the principal amount of the instrument be written down on a permanent or temporary basis or the instrument be converted to one or more common equity Tier 1 instruments; and
 - (ii) the trigger mechanism in (i) is different from, or additional to, any discretionary mechanism for converting or writing down the principal amount of the instrument which is activated following a determination by the relevant authority that the issuer of the *financial instrument* (or its *group*, or any member of its *group*) is no longer viable, or will no longer be viable unless the relevant instrument is converted or written down;

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.

Annex B

Amendments to the Conduct of Business sourcebook (COBS)

In this part, underlining indicates new text and striking through indicates deleted text, unless stated otherwise.

Part 1: Comes into effect on 1 July 2015

4.12 Restrictions on the promotion of non-mainstream pooled investments

...

Electronic documents

4.12.14 G In this section:

- (1) any requirement that a document is signed may be satisfied by an electronic signature or electronic evidence of assent; and
- (2) any references to writing should be construed in accordance with GEN 2.2.14R and its related guidance provisions.

Insert the following new section after COBS 22.1. The text is not underlined.

22.2 Requirements on the retail distribution of mutual society shares

Application

- 22.2.1 R (1) The requirements in this section apply to a *firm* when *dealing* in or *arranging a deal* in a *mutual society share* with or for a *retail client* in the *EEA* where the *retail client* is to enter into the *deal* as buyer.
- (2) The requirements in this section do not apply if:
- (a) the *firm* has taken reasonable steps to ensure that one (or more) of the exemptions in *COBS 22.2.4R* applies; or
 - (b) the *deal* relates to the trading of a *mutual society share* in the secondary market.
- (3) In this section, a *retail client* of the *firm* includes a *person* who would be a *retail client* if he were receiving services in the course of the *firm* carrying on a *regulated activity*.

Risk warning requirement

- 22.2.2 R The *firm* must give the *retail client* the following risk warning on paper or another *durable medium* and obtain confirmation in writing from the *retail client* that he has read it, in good time before the *retail client* has committed

to buy the *mutual society share*:

“The investment to which this communication relates is a share. Direct investment in shares can be high risk and is very different to investment in deposit accounts or other savings products. In particular, you should note that:

- (a) the entire amount you invest is at risk;
- (b) income, distribution or dividend payments are not guaranteed, are entirely discretionary, and may be suspended or cancelled at any time, for any reason;
- (c) the share is a perpetual instrument with no maturity date, and there is no obligation on the issuer to buy the share back;
- (d) the share may be difficult to sell on for the price you paid for it, or any price; and
- (e) investing more than 10% of your savings or net investment portfolio in this type of instrument is unlikely to be in your best interests.”

Further requirements for non-advised, non-MiFID sales

- 22.2.3 R (1) The requirements in (2) and (3) must be met if:
- (a) the *firm* is not providing an *investment service* in the course of *MiFID or equivalent third country business*; and
 - (b) the *retail client* is not otherwise receiving *advice* on the *mutual society share* from the *firm* or another *person*.
- (2) The *firm* must give the *retail client* the following statement on paper or another *durable medium* and obtain confirmation in writing from the *retail client* that he has signed it, in good time before the *retail client* has committed to *buy the mutual society share*:
- “I make this statement in connection with proposed investment in mutual society shares. I have been made aware that investing more than 10% of my net assets in mutual society shares is unlikely to be in my best interests. I declare that the proposed investment would not result in more than 10% of my net assets being invested in mutual society shares. Net assets for these purposes mean my financial assets after deduction of any debts I have, and do not include:
- (a) the property which is my primary residence, any amount owed under a mortgage relating to the purchase of that property, or any money raised through a loan secured on that property;
 - (b) any rights of mine under a qualifying contract of insurance (for example, a life assurance or critical illness policy); or

- (c) any benefits (in the form of pensions or otherwise) which are payable on the termination of my service or on my death or retirement and to which I am (or my dependants are) or may be entitled.

I accept that the investment to which this statement relates will expose me to a significant risk of losing all the money invested.

Signature:

Date: ”

- (3) The *firm* must assess whether investment in the *mutual society share* is appropriate for the *retail client*, complying with the requirements in *COBS 10* as though the *firm* was providing non-advised *investment services* in the course of *MiFID* or *equivalent third country business*.

Exemptions

- 22.2.4 R Each of the exemptions listed below applies only if the *retail client* is of the type described for the exemption and provided any additional conditions for the exemption are met.

| Title | Type of retail client | Additional conditions |
|--|--|---|
| <i>Certified high net worth investor</i> | <p>(a) An individual who meets the requirements set out in <i>COBS 4.12.6R</i>; or</p> <p>(b) an individual in an <i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.6R</i>; or</p> <p>(c) a <i>person</i> (or <i>persons</i>) legally empowered to make investment decisions on behalf of an individual who meets the earnings or net asset requirements in (a) or (b) above.</p> | The <i>firm</i> must consider that the <i>mutual society share</i> is likely to be suitable for that individual, based on a preliminary assessment of that individual's profile and objectives (see <i>COBS 4.12.5G(2)</i>). |
| <i>Certified sophisticated investor</i> | <p>(a) An individual who meets the requirements set out in <i>COBS 4.12.7R</i>; or</p> <p>(b) an individual in an</p> | Not applicable. |

| | | |
|--|---|-----------------|
| | <p><i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.7R</i>; or</p> <p>(c) an individual who meets the requirements for either (a) or (b) above and who is legally empowered (solely or jointly with others) to make investment decisions on behalf of another person who is the <i>firm's client</i>.</p> | |
| <i>Self-certified sophisticated investor</i> | <p>(a) An individual who meets the requirements set out in <i>COBS 4.12.8R</i>; or</p> <p>(b) an individual in an <i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.8R</i>; or</p> <p>(c) an individual who meets the requirements for either (a) or (b) above and who is legally empowered (solely or jointly with others) to make investment decisions on behalf of another <i>person</i> who is the <i>firm's client</i>.</p> | Not applicable. |

Adaptation of other rules and guidance to mutual society shares

- 22.2.5 R (1) For the purposes of any assessments or certifications required by the exemptions in *COBS 22.2.4R*, any references in *COBS 4.12* provisions to *non-mainstream pooled investments* must be read as though they are references to *mutual society shares*.
- (2) If the *firm* is relying on the exemptions for *certified high net worth*

investors, certified sophisticated investors or self-certified sophisticated investors to comply with this section, the statement the investor must sign should have references to *non-mainstream pooled investments* replaced with references to *mutual society shares*.

- (3) The *firm* must give the *retail client* a written copy of any risk warning or statement that that individual has been asked to sign for the purposes of compliance with this section.

Record keeping

- 22.2.6 R A *firm* which carries on an activity which is subject to this section must comply with the following record-keeping requirements:
- (1) the *person* allocated the *compliance oversight function* in the *firm* must make a record at or near the time of the activity certifying it complies with the requirements set out in this section;
 - (2) the making of the record required in (1) may be delegated to one or more *employees* of the *firm* who report to and are supervised by the *person* allocated the *compliance oversight function*, provided the process for certification of compliance has been reviewed and approved by the *person* allocated the *compliance oversight function* no more than 12 months before the date of the *deal*;
 - (3) the record in (1) must include information and evidence demonstrating compliance with each of the requirements in this section, as applicable;
 - (4) if the requirements in *COBS 22.2.2R* and *COBS 22.2.3R* did not apply because the *firm* relied on one of the exemptions, the record in (1) must include which exemption was relied on, together with the reason why the *firm* is satisfied that that exemption applies;
 - (5) where the *firm* relies on the *certified high net worth investor*, the *certified sophisticated investor* or the *self-certified sophisticated investor* exemption, the record required in (1) must include a copy of the certificate or investor statement (as signed by the investor) and of the warnings or indications required by the exemption;
 - (6) a *firm* must retain the record required in (1) for five years if it relates to *MiFID* or *equivalent third country business*, and otherwise for three years.

Electronic documents

- 22.2.7 G In this section:
- (1) any requirement that a document is signed may be satisfied by an electronic signature or electronic evidence of assent; and

- (2) any references to writing should be construed in accordance with GEN 2.2.14R and its related *guidance* provisions.

Amend the following as shown.

Schedule 1 Record keeping requirements

...

Sch 1.3G

| Handbook reference | Subject of record | Contents of record | When record must be made | Retention period |
|---------------------|---|---|---|--|
| COBS 20.3.1R | ... | | | |
| <u>COBS 22.2.6R</u> | <u>Retail distribution of mutual society shares</u> | <u>Information and evidence demonstrating compliance with the requirements of COBS 22.2</u> | <u>At or near the time of the sale to a retail client</u> | <u>5 years for MiFID or equivalent third country business and 3 years for other business</u> |
| ... | | | | |

Part 2: Comes into effect on 1 October 2015

9.3 Guidance on assessing suitability

...

Non-mainstream pooled investments Investments subject to restrictions on retail distribution

- 9.3.5 G (1) ~~*Firms should note that section 238 of the Act and COBS 4.12.3R set out restrictions on the promotion of non-mainstream pooled investments to retail clients. Firms should note that restrictions and specific requirements apply to the retail distribution of certain investments:*~~
- (a) non-mainstream pooled investments are subject to a restriction on financial promotions (see section 238 of the Act and COBS 4.12);
- (b) non-readily realisable securities are subject to a restriction on direct offer financial promotions (see COBS 4.7);

- (c) contingent convertible instruments and CoCo funds are subject to a restriction on sales and on promotions (see COBS 22.3);
- (d) mutual society shares are subject to specific requirements in relation to dealing and arranging activities (see COBS 22.3).
- (2) (a) ~~Firms should bear in mind that the provision of advice or information may involve the communication of a financial promotion (see PERG 8). In particular, making a personal recommendation that a client should enter into a non-mainstream pooled investment will generally amount to a financial promotion of that investment because a personal recommendation typically includes an invitation or inducement to engage in investment activity.~~
- (b) ~~Due to the restrictions in section 238 of the Act and COBS 4.12.3R, the promotion of a non-mainstream pooled investment to a retail client is not permitted except where a valid exemption is available and relied on by the firm communicating the promotion. Firms should therefore first satisfy themselves that an exemption is available in relation to the promotion of the non-mainstream pooled investment before recommending the investment to a retail client. A firm should be satisfied that an exemption is available before recommending an investment subject to a restriction on distribution to a retail client, noting in particular that a personal recommendation to invest will generally incorporate a financial promotion.~~
- (3) (a) In addition to assessing whether the promotion is permitted, a firm giving advice on a non-mainstream pooled investment designated investment subject to a restriction on distribution should comply with their obligations in COBS 9 and ensure any *personal recommendation* is suitable for its client.
- (b) ~~In considering its obligations under COBS 9, a firm purchasing a non-mainstream pooled investment on behalf of a client as part of a discretionary management agreement should have regard to whether that client is a person to whom promotion of that non-mainstream pooled investment is permissible under COBS 4.12.4R(5). Whilst the restriction in COBS 4.12.3R does not affect transactions where there is no prior communication with the client in connection with the transaction, a discretionary investment manager should exercise particular care to satisfy himself that the transaction is suitable for the client and that it is in that client's best interests, if promotion of the investment would not have been permitted.~~

- (i) In considering its obligations under COBS 9, a firm purchasing a *designated investment* subject to a restriction on distribution on behalf of a *retail client* as part of a discretionary management agreement should exercise particular care to ensure the transaction is suitable and in that *client's* best interests, having regard to the *FCA's* view that such *designated investments* pose particular risks of inappropriate distribution.
- (ii) A restriction on promotion does not affect a transaction where there has been no prior communication with the *client* in connection with the investment by the *firm* or a *person* connected to the *firm*. Nonetheless, if promotion of a *designated investment* to a *retail client* would not have been permitted, then the discretionary manager's decision to purchase it on behalf of the *retail client* should be supported by detailed and robust justification of his assessment of suitability.

...

Insert the following new section after COBS 22.2. The text is not underlined.

22.3 Restrictions on the retail distribution of contingent convertible instruments and CoCo funds

Restrictions

- 22.3.1 R (1) The restrictions in this section apply in relation to the following *investments*:
- (a) a *contingent convertible instrument*; or
 - (b) a *security* issued by a *CoCo fund*; or
 - (c) a beneficial interest in either of (a) or (b).
- (2) A *firm* must not:
- (a) *sell an investment* to a *retail client* in the *EEA*; or
 - (b) communicate or approve an invitation or inducement to participate in, acquire or underwrite an *investment* where that invitation or inducement is addressed to or disseminated in such a way that it is likely to be received by a *retail client* in the *EEA*.
- (3) The restrictions do not apply if the *firm* has taken reasonable steps to

ensure that one (or more) of the exemptions in *COBS 22.3.2R* applies.

- (4) In this section a *retail client* includes a *person* who would be a *retail client* if he were receiving services from the *firm* in the course of the *firm* carrying on a *regulated activity*.

Exemptions

- 22.3.2 R Each of the exemptions listed below applies only if the *retail client* is of the type described for the exemption and provided any additional conditions for the exemption are met.

| Title | Type of retail client | Additional conditions |
|--|--|---|
| <i>Certified high net worth investor</i> | (a) An individual who meets the requirements set out in <i>COBS 4.12.6R</i> ; or (b) an individual in an <i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.6R</i> ; or (c) a <i>person</i> (or <i>persons</i>) legally empowered to make investment decisions on behalf of an individual who meets the earnings or net asset requirements in (a) or (b) above. | The <i>firm</i> must consider that the <i>investment</i> is likely to be suitable for that individual, based on a preliminary assessment of that individual's profile and objectives (see <i>COBS 4.12.5G(2)</i>). |
| <i>Certified sophisticated investor</i> | (a) An individual who meets the requirements set out in <i>COBS 4.12.7R</i> ; or (b) an individual in an <i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.7R</i> ; or (c) an individual who meets the requirements for | Not applicable. |

| | | |
|--|---|--|
| | either (a) or (b) above and who is legally empowered (solely or jointly with others) to make investment decisions on behalf of another person who is the <i>firm's client</i> . | |
| <i>Self-certified sophisticated investor</i> | <p>(a) An individual who meets the requirements set out in <i>COBS 4.12.8R</i>; or</p> <p>(b) an individual in an <i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.8R</i>; or</p> <p>(c) an individual who meets the requirements for either (a) or (b) above and who is legally empowered (solely or jointly with others) to make investment decisions on behalf of another <i>person</i> who is the <i>firm's client</i>.</p> | The <i>firm</i> must consider that the <i>investment</i> is likely to be suitable for that individual, based on a preliminary assessment of that individual's profile and objectives (see <i>COBS 4.12.5G(2)</i>). |
| Solicited advice | Any <i>retail client</i> . | <p>The restrictions do not apply provided all of the following requirements are met:</p> <p>(a) there is no invitation or inducement to participate in, acquire or underwrite the <i>investment</i> other than a <i>personal recommendation</i> on the <i>investment</i>;</p> <p>(b) the <i>personal recommendation</i> is made following a specific request by that <i>client</i> for advice on the <i>investment</i>; and</p> <p>(c) the <i>client</i> has not previously received any other</p> |

| | | |
|---|---|---|
| | | communication (whether or not a <i>financial promotion</i>) from the <i>firm</i> or from a <i>person</i> connected to the <i>firm</i> which is intended to influence the <i>client</i> in relation to the <i>investment</i> . (See Note 1) |
| <i>MiFID or equivalent third country business other than financial promotions</i> | Any <i>retail client</i> . | <i>COBS 22.3.1R(2)(a)</i> does not apply to <i>MiFID or equivalent third country business</i> (see <i>COBS 9.3.5G</i>). |
| Prospectus | Any <i>retail client</i> . | The restrictions do not apply to the distribution of a prospectus required under the <i>Prospectus Directive</i> . |
| Indirect investment | Any <i>retail client</i> | The restrictions do not apply in relation to a beneficial interest in a <i>contingent convertible instrument</i> acquired through participation in a <i>regulated collective investment scheme</i> , investment in a <i>non-mainstream pooled investment</i> (provided it is not a <i>CoCo fund</i>), or membership of an <i>occupational pension scheme</i> . |
| Note 1 | A <i>person</i> is connected with a <i>firm</i> if it acts as an <i>introducer</i> or <i>appointed representative</i> for that <i>firm</i> or if it is any other <i>person</i> , regardless of <i>authorisation</i> status, who has a relevant business relationship with the <i>firm</i> . | |
| Note 2 | See <i>COBS 2.4</i> for rules and guidance on agent as <i>client</i> and reliance on others. | |

Adaptation of other rules and guidance to contingent convertible instruments and CoCo funds

- 22.3.3 R (1) For the purposes of any assessments or certifications required by the exemptions in *COBS 22.3.2R*, any references in *COBS 4.12* provisions to *non-mainstream pooled investments* must be read as though they are references to *contingent convertible instruments* or *CoCo funds*, as relevant.
- (2) If the *firm* is relying on the *high net worth investor*, the *sophisticated*

investor or the *self-certified sophisticated investor* exemption to comply with this section, the statement the investor must sign should have references to *non-mainstream pooled investments* replaced with references to *contingent convertible instruments* or *CoCo funds*, as relevant.

- (3) The *firm* must give the *retail client* a written copy of any statements that individual has been asked to sign as part of certification as a *high net worth, sophisticated* or *self-certified sophisticated investor* for the purposes of compliance with this section.

- 22.3.4 G A *firm* wishing to certify a *retail client* as a sophisticated investor for the purposes of this section should note that, in the *FCA's* view, it is likely that the only *retail clients* with the requisite sophistication in relation to *contingent convertible instruments* or *CoCo funds* are those with significant experience with investment in multiple types of complex *financial instruments* and who have sufficient understanding of how *credit institutions* are run, including risks to the ability of those institutions to meet prudential requirements on an ongoing basis.

Record keeping

- 22.3.5 R A *firm* which carries on an activity which is subject to this section must comply with the following record-keeping requirements:
- (1) the *person* allocated the *compliance oversight function* in the *firm* must make a record at or near the time of the activity certifying it complies with the restrictions set out in this section;
 - (2) the making of the record required in (1) may be delegated to one or more *employees* of the *firm* who report to, and are supervised by, the *person* allocated the *compliance oversight function*, provided the process for certification of compliance has been reviewed and approved by the *person* allocated the *compliance oversight function* no more than 12 months before the date of the sale or communication or approval of the invitation or inducement;
 - (3) when making the record required in (1), the *firm* must make a record of which exemption was relied on for the purposes of the activity within the scope of this section, together with the reason why the *firm* is satisfied that that exemption applies;
 - (4) where the *firm* relies on the *certified high net worth investor*, the *certified sophisticated investor* or the *self-certified sophisticated investor* exemption, the record in (1) must include a copy of the certificate or investor statement (as signed by the investor) and of the warnings or indications required by the exemption, as applicable;
 - (5) a *firm* must retain the record required in (1) for five years if it relates to *MiFID* or *equivalent third country business*, and otherwise for three years.

- 22.3.6 G To the extent the requirements in *COBS* 22.3.5R apply to the communication or approval of any invitation or inducement, such requirements are in addition to those set out in *COBS* 4.11.

Amend the following as shown.

Schedule 1 Record keeping requirements

...

Sch 1.3G

| Handbook reference | Subject of record | Contents of record | When record must be made | Retention period |
|----------------------------|---|--|---|--|
| ... | | | | |
| <i>COBS</i> 22.2.6R | ... | | | |
| <u><i>COBS</i> 22.3.5R</u> | <u>Retail distribution of contingent convertible instruments and CoCo funds</u> | <u>Information and evidence demonstrating compliance with the restrictions in <i>COBS</i> 22.3</u> | <u>At or near the time of the sale or communication or approval of a promotion to a retail client</u> | <u>5 years for MiFID or equivalent third country business and 3 years for other business</u> |
| ... | | | | |



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