

Temporary product intervention rules

Restrictions in relation to the retail distribution of contingent convertible instruments

August 2014

Introduction

1. Contingent convertible instruments (commonly known as CoCos) are hybrid capital securities that absorb losses when the capital of the issuer falls below a certain level. They are risky and highly complex instruments that, in the coming years, are likely to be issued in large amounts by financial institutions such as banks and building societies as a result of new prudential requirements being implemented in response to the financial crisis.
2. We regard CoCos as posing particular risks of inappropriate distribution to ordinary retail customers (i.e. retail clients who are neither sophisticated nor high net worth or who do not meet any of the other permitted criteria set out in the rules shown in Annex 2). Given the pressures to maintain a prudent capital position and the current low interest rate environment, there is a significant risk that these loss-absorbing instruments will be inappropriately promoted to retail investors searching for yield and income.
3. The European Supervisory Authorities (ESAs) have recently issued two communications to firms and investors of the risks of these instruments.¹
4. The Financial Conduct Authority (FCA) has now made temporary product intervention rules, which will come into effect on 1 October 2014 and lapse on 1 October 2015. These rules impose restrictions in relation to the distribution of CoCos to retail investors.
5. This communication explains the scope of the temporary rules and exemptions available, as well as providing the FCA's rationale for making temporary rules. It also explains how these temporary rules interact with our upcoming consultation on permanent rules for CoCos.

¹ <http://www.esma.europa.eu/content/Placement-financial-instruments-depositors-retail-investors-and-policy-holders-Self-placemen> and <http://www.esma.europa.eu/content/Potential-Risks-Associated-Investing-Contingent-Convertible-Instruments>

Scope of the temporary rules

6. The temporary rules apply to all authorised persons in the UK, including both issuers of CoCos and firms promoting or intermediating transactions in CoCos. The rules have no effect in relation to the distribution of CoCos to professional or institutional clients, or to exempt persons. The rules do not restrict the distribution of prospectuses issued in compliance with the Prospectus Directive, and do not apply to clearing, registration, settlement, custodial or back office processing services.
7. For the purposes of the temporary rules, investment in CoCos does not include indirect exposure via investment funds or occupational pension schemes. The rules apply even if there is no client relationship between the firm and the retail investor (as may be the case in relation to sales by the issuer, for example).
8. In relation to retail investors, the rules generally do not permit firms to sell, promote or intermediate transactions in CoCos that would result in ordinary retail investors investing in CoCos. However, to the extent a firm's activities amount to MiFID or equivalent third country business, the rules only apply restrictions in relation to promotional activities and not to the sale or intermediation of the transaction in CoCos.
9. Firms engaging in MiFID or equivalent third country business are reminded that compliance with the restrictions on promotion introduced by the temporary rules does not exhaust their regulatory responsibilities. Their duties under the client's best interest rule (COBS 2.1.1R) as well as the suitability (COBS 9) and appropriateness (COBS 10) rules are particularly relevant in the context of intermediation of transactions in CoCos for retail clients.
10. Whether or not the activities amount to MiFID or equivalent third country business, a number of exemptions are provided in relation to the restrictions in the temporary rules. Subject to conditions, firms may sell, promote or intermediate transactions in CoCos (as the case may be) if the retail investor is certified as a high net worth investor, sophisticated investor, or self-certified sophisticated investor, or if the consumer has specifically requested advice without receiving previous communications from the firm about investment in CoCos.
11. The rules also require firms to make a record of their assessment of the retail investor under the available exemptions where they promote (or approve financial promotions of) investment in CoCos. These records must be made by the firm's compliance function, and the person allocated the compliance oversight function at the firm must review the certification process at least every 12 months.
12. Where firms make a promotion to a sophisticated or high net worth individual, we expect the firm to give the client a written copy of the relevant statement signed by the individual.
13. Firms are reminded of our existing rules and guidance in COBS 2.4 on treating agents as clients and on reliance on information provided by other persons. A firm is generally able to treat as a client another firm acting as agent for an end-client. The firm can rely on information about the end-client given to it by that firm. Even where the intermediary firm is not acting as agent for an end-client, in determining whether they comply with the temporary rules, a firm may generally rely on information provided in writing by another person, if it can show it was reasonable to do so.

The FCA's rationale for intervention

14. CoCos are highly complex, hybrid capital instruments with loss-absorbency features written into their contractual terms. One key characteristic is that they feature an equity conversion or writing down trigger, set with reference to the issuer's capital position in relation to regulatory requirements. 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 may never be called. 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 and model.
15. CoCos help inhibit risk transfer from investors to taxpayers. That is, in times of financial stress for the issuer, it is intended that investors should bear the costs of recapitalisation without the need for public funds. This is an important role but highlights a particular concern from a conduct perspective: CoCos are not designed to meet an identified need of target market investors. Their design is largely dictated by requirements for regulatory capital. Many of their characteristics are highly unusual and largely untested, which means the risk/benefit ratio may operate in ways even sophisticated investors do not expect. Features that relate to the issuer's ongoing capital position may be opaque in their operation and risks. Furthermore, risks to investors that flow from the possibility of the issuer's exercise of discretion are extremely difficult to evaluate.
16. Overall, these are securities that are inappropriate for distribution to ordinary retail investors. Despite significant market appetite for these instruments, there is growing concern that even professional investors may struggle to evaluate and price CoCos properly. This suggests that firms selling, promoting or intermediating transactions for sophisticated or high net worth retail clients should be particularly careful to safeguard the interests of those consumers.
17. The FCA has been developing a considered approach to the conduct risks posed by the distribution of CoCos. We have been working closely with UK issuers over the last 16 months to ensure the new securities are marketed in a way that minimises the risk of inappropriate investment by ordinary retail investors. This has largely been achieved through voluntary agreement by issuers of high minimum denomination values.
18. We first outlined our concerns about CoCos in Policy Statement 13/3 in June 2013.² In that statement, we noted that we planned to consult on a new marketing restriction and that we would work with issuers in the meantime. We also noted that 'one option is to introduce an interim marketing restriction through a temporary product intervention rule to address the risks to consumers while we work on consulting on and introducing permanent rules'.
19. With an increasing number of new issues of CoCos expected in the coming months and years, we believe the supervisory approach explained above is no longer appropriate or an efficient use of FCA resources. We are also concerned that it may not offer sufficient protection to consumers, for example in relation to inappropriate distribution of CoCos issued overseas. While we are now in the final stages of developing our approach for the consultation exercise in relation to CoCos, we are also concerned that it is likely to be several months until permanent rules are in place.

² <http://www.fca.org.uk/static/documents/policy-statements/ps13-03.pdf>

20. We have therefore decided to exercise the option to make temporary rules to address the risks to consumers of inappropriate distribution of these securities. The new rules will apply equally to CoCos issued in the UK or overseas. We believe they will ensure more comprehensive and consistent protection for consumers while moving to a more transparent regulatory approach that gives greater certainty and predictability for firms. They represent a development of the FCA's prompt response to the risks identified in this market, from an initial case-by-case approach to the introduction of interim standards applying to all firms, to be replaced by permanent rules after the consultation process is concluded.
21. The Financial Services and Markets Act 2000 (FSMA) (as amended by the Financial Services Act 2012) introduced explicit powers to make product intervention rules (s. 137D). Section 138M provides that the FCA may make product intervention rules without consultation (and without complying with other requirements under FSMA, such as conducting a cost benefit analysis) if it considers it necessary or expedient to do so to advance the consumer protection objective or the competition objective (or the integrity objective if the requisite order is made by Treasury). Product intervention rules made in this way may last for a maximum of 12 months and are known as temporary product intervention rules.
22. In our statement of policy in relation to how we intended to use this rule-making power, we said that the FCA's main consideration will generally be whether prompt action is deemed necessary in seeking to reduce or prevent consumer detriment.³ We consider this intervention to be in keeping with our statement of policy and with the requirements of s. 138M FSMA.
23. We are introducing restrictions in relation to the retail distribution of CoCos as temporary product intervention rules with effect from 1 October 2014 and lasting for 12 months. The rules relate to CoCos eligible as either AT1 or Tier 2 (T2) capital under Regulation (EU) No 575/2013 (the Capital Requirements Regulation or CRR).⁴ As explained above, the restrictions will limit the ability of firms to distribute CoCos to retail customers: the firm will first be required to check that the customer falls within one of the permitted categories.
24. The temporary restrictions will apply to the distribution of new issues and of investments on the secondary market, including promotions to UK investors of securities issued abroad.
25. In September this year, we are planning to publish a consultation paper about proposed permanent rules on CoCos. After we have considered the feedback, we aim to publish a policy statement in Q2 2015, with final rules to be scheduled to take effect on 1 October 2015, when the temporary product intervention rules expire.

Modification of rules

26. Temporary product intervention rules are by their very nature made without prior consultation and thus will not undergo the usual process for testing draft rules and receiving and considering feedback from the public before they are made. While every effort has been made to ensure these temporary rules have the effect described in this communication, we are aware of the possibility of unintended consequences.

³ <http://www.fca.org.uk/static/documents/consultation-papers/fsa-ps13-03.pdf>

⁴ Regulation (EU) No 575/2013

27. As such, we would welcome comments from any firms, organisations or members of the public who believe they have identified ways in which the drafting of the temporary rules may depart from their intended effect. While inviting such comments should not be perceived as amounting to a consultation exercise, we would particularly welcome comments received before the rules come into force on 1 October 2014.
28. We would also note that the waivers process is potentially available to firms subject to the temporary rules. It provides a route for modifying the rules in specific or narrow circumstances where they would not work as intended. As explained on our website, we will consider granting a waiver if the firm is able to demonstrate that (a) complying with the rule would be unduly burdensome or would not achieve its purpose, and (b) the waiver would not adversely affect any of our operational objectives. Our operational objectives are to secure an appropriate degree of protection for consumers, to protect and enhance the integrity of the UK financial system, and to promote effective competition in the interests of consumers.

If you have any comments you can send them in writing to:

Jason Pope or Leonor Dormido Jordá
Policy, Risk and Research Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London, E14 5HS

Email: Jason.Pope@fca.org.uk or Leonor.Dormido-Jorda@fca.org.uk

We will make responses available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

Annex 1: Considerations for the use of the temporary product intervention rule-making power

Intended outcomes and links to FCA's objectives

29. The temporary product intervention rules are designed to advance the FCA's objective of securing an appropriate degree of consumer protection by preventing the distribution of CoCos to consumers for whom they are unlikely to be suitable.
30. Issuers in some other jurisdictions have used self-placement distribution models to sell similar capital instruments to their retail clients. In some cases it appears that the majority of sales, up to 75%, were to retail investors. The loss per customer in some cases has been over 80% of their initial investment.
31. If a CoCo is triggered, there is also likely to be a contagion effect to other instruments as the market reacts. In one survey, for example, it was reported that, on average, investors expect a 9% drop in prices across the market on the first deferral of coupons, and a 15% drop in market prices following a conversion.⁵ Therefore, ordinary retail investors with holdings of instruments from different issuers may also face detriment.
32. We are acting now to prevent detriment to ordinary retail investors in the UK. The FCA's regulatory approach favours intervention in problematic markets to prevent consumer detriment occurring in the first place rather than to remedy it after it arises. Without the introduction of these rules, we believe it is possible that ordinary retail investors in the UK are likely to be exposed to instruments that are not appropriate for their needs and which may lead to detriment.
33. We are also taking into account our objective of promoting effective competition in the interests of consumers. By aligning the ability of firms to promote these securities to the consumers for whom they are most likely to be suitable, we believe our approach will promote effective competition in the interests of consumers, rather than allowing firms to compete for capital from consumers for whom these securities are likely to be not suited.
34. The FCA statement of policy on the use of temporary product intervention rules sets out as the key consideration that, in deciding whether the rule should be made as a temporary product intervention rule, our main consideration will generally be whether prompt action is deemed necessary in seeking to reduce or prevent consumer detriment arising from that product, type of product or practices. The policy statement on the use of temporary product intervention rules also lists a number of factors that the FCA will take into account, as a minimum, when considering making a rule in this way. Below we set out our assessment of those factors for this issue.

Whether prompt action is necessary

35. Between 2009 and 2013, the amount of CoCos issued by banks is estimated to have reached around \$70 billion (approximately £40 billion).⁶ 20.7% of this issuance was from UK banks.

⁵ *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>

⁶ *CoCos: a primer*, BIS Quarterly Review, September 2013, Bank of International Settlements, http://www.bis.org/publ/qtrpdf/r_qt1309f.pdf

36. In the June 2014 *Financial Stability Report*,⁷ the Bank of England noted that European issuance of AT1 has accelerated sharply over the past 18 months. The report estimated that, if the largest four UK banks issued AT1 up to 1.5% of risk-weighted assets, this would lead to additional issuance of around £22 billion (around £7 billion has been issued to date).
37. In a report earlier this year, Bank of America Merrill Lynch estimated the European AT1 CoCo market could grow to more than €150 billion by 2020.⁸ The market is therefore expected to grow rapidly in the coming years.
38. Increasing issuance of CoCos to meet prudential capital requirements might lead to the marketing of these instruments to ordinary retail investors, who would not be able to assess the risks entailed adequately. Given the possible scale of potential detriment to retail clients that might result, we believe that prompt action is necessary.
39. Further, we note that it would be possible for UK entities to issue instruments in other jurisdictions, avoiding our involvement in shaping prospective issues, then to market those instruments to retail clients via a UK branch network.
40. Making temporary product intervention rules avoids these risks and focuses sales on those clients better placed to understand the risks and make informed investment decisions. It also minimises the delay until these measures are in place. This approach also adds certainty and transparency of our approach to the market, with greater clarity than our existing case-by-case approach has been able to achieve.

Appropriate and effective means of addressing actual or potential consumer detriment associated with a particular product or group of products

41. We do not believe that CoCos are generally suitable for the retail market. While to date we have protected the UK retail market from CoCo issuances using case-by-case supervisory measures, the growing number of issuances is likely to put increasing strain on this approach and cannot influence non-UK issuances.
42. Securities presenting similar characteristics have caused significant detriment in other jurisdictions. The temporary product intervention rules prevent this situation occurring in the UK and limit retail access to those clients who are better placed to understand the risks.

A proportionate and deliverable means of addressing actual or potential detriment

43. The temporary product intervention rules are focused on reducing risk to ordinary retail investors, while still allowing other investors access to these securities. We consider this to be a proportionate response to the risks of consumer detriment. Our previous work on marketing restrictions on non-mainstream investments shows that it is a deliverable means of addressing the risk.

⁷ *Financial Stability Report*, issue 35, June 2014, Bank of England ,
<http://www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf>

⁸ Bank of America Merrill Lynch, *Contingent Capital – what we think*, 14 January 2014

Compatible with the FCA's duty to promote effective competition in the interests of consumers

44. In making any rule, including temporary product intervention rules, the FCA seeks to promote effective competition in the interests of consumers where doing so is compatible with advancing its consumer protection objective (or the integrity objective). In assessing the impact of the proposed temporary product intervention rule, we have considered the following points:
- whether there is reasonable scope for the rule to promote effective competition in the interests of consumers, for instance by addressing consumer behaviours that impair their ability to benefit from competition, by reducing information asymmetries or by correcting misaligned incentives
 - whether the rule may have a negative impact on competition factors such as product innovation and barriers to entry for new market participants
 - whether any negative impact on competition factors is proportionate, having regard to the aims of the rule
 - whether alternative solutions may deliver the same intended outcome while having a more positive impact on competition, and
 - the overall effect of the proposed rule upon the operation of effective competition in the market for financial services, having regard to the interests of consumers
45. To exert effective competitive pressure, consumers need to assess quality and price (value) adequately. As noted above, the information asymmetries apparent in the market for these instruments are profound. Further, behavioural biases are expected to play a significant role in this market were we to leave it unchecked. The current low interest rate environment and the focus on finding yield, particularly by clients who only have experience in cash savings, is likely to lead to a focus on headline rates without a sufficient understanding of the nature and risks of the instruments or a fair assessment of value for money.
46. We do not consider that other solutions, such as additional disclosure, are likely to be sufficiently effective in this sector, or to have a more positive impact on competition, given the need for specialised knowledge and the highly complex, unfamiliar, and untested, nature of these securities.
47. For these reasons, we conclude that limiting access to CoCos is compatible with ensuring that distributors of investments compete to promote suitable – rather than unsuitable – investments to ordinary retail investors. On the other hand, these securities are more likely to be suitable for high net worth and sophisticated investors in the retail market. Those consumers are more likely to be able to engage effectively in this market without suffering from information asymmetries to the same extent.
48. We believe the rules will promote effective competition in the interests of consumers by aligning the ability of firms to offer CoCos to those consumers for whom they are most likely to be suitable in the retail market. We do not expect this to have a negative impact on competition but it should prove beneficial by reducing the widespread concerns that these securities might otherwise reach sectors of the markets for which they are inappropriate.

49. Overall, we expect the measures to improve consumer outcomes by limiting the scope for firms to exploit information asymmetries and consumer biases. This will reduce firms' ability to interest ordinary retail investors in securities that are unlikely to be suitable for them. We believe this will make competition work more effectively in the interests of consumers by helping refocus competition on the promotion of investments that are a better match to the investors to whom they are marketed.

Supported by sufficient and appropriate evidence

50. As a fairly new market development – and one that has been controlled to date in the UK through FSA and FCA supervisory measures – there is no evidence of actual consumer detriment in the UK. We consider, however, that there is a significant body of evidence (as set out above) of the need to control the distribution of these securities to ordinary retail investors.

Transparent in aim and operation

51. We consider that the temporary product intervention rules are clearly drafted and easy for distributors to interpret and follow. We also consider that introducing temporary intervention rules provides legal certainty for issuers during the interim before implementation of the final rules on which we will be consulting in due course.

Likely to be beneficial for consumers, when taken as a whole

52. The approach we follow will protect ordinary retail clients but still allow retail market access to these instruments, if consumers meet relevant requirements. Investors for whom these are generally unsuitable will be protected, but investors for whom they may be suitable will be able to access them. Nor will we prevent issuers from accessing a new source of regulatory capital. As a whole, therefore, we believe that this approach will prove net beneficial overall for consumers and the industry.

The impact on protected groups in the Equality Act and whether the rule promotes equality and good relations

53. In introducing retail distribution restrictions as temporary product intervention rules, we aim to protect all ordinary retail investors, including those in the protected groups under the Equality Act, by stopping retail distribution that is unlikely to be suitable.

EU considerations

54. We consider our approach to be consistent with the ESA statements and relevant EU legislation, including MiFID,⁹ the Prospectus Directive¹⁰ and CRD IV.¹¹
- MiFID prevents us from introducing sales restrictions but, while it has some provisions relating to the conduct of marketing, it does not harmonise rules in relation to marketing limitations and therefore we believe the introduction of marketing restrictions in the manner proposed is consistent with MiFID. It is for these

⁹ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 011/61/EU

¹⁰ Directive 2003/71/EC

¹¹ Comprising the Capital Requirements Directive (EU Directive 2013/36/EU) and the Capital Requirements Regulation (EU Regulation 575/2013)

reasons that, where a transaction amounts to MiFID business, the restrictions we are introducing apply only with regard to financial promotions.

- While the Prospectus Directive allows the free dissemination of prospectuses across the EEA (and so we have included a specific exemption for firms disseminating prospectuses), any ancillary communication (including a verbal communication, leaflets, websites or other documentation provided at the same time) would be subject to the marketing restriction.
- CRD IV sets prudential requirements with which institutions must comply, which includes requirements concerning CoCos. CRD IV does not impose requirements on the retail distribution of these instruments; we therefore believe that the rules are permissible under CRD IV.

55. We have also considered the recent publications by the European Supervisory Authorities with regard to CoCos.

- ESMA recently published a Statement on potential risks associated with investing in contingent convertible instruments. The Statement highlights the difficulties presented for investors in correctly assessing the risks of this type of instruments. It also informs investors of the different risks that these instruments present and asks for a careful consideration of those to be made prior to their acquisition.
- The reminder to credit institutions and insurance undertakings about applicable regulatory requirements issued by the Joint Committee of the ESAs includes a reference to past experience in Member States where institutions placed their own capital instruments with retail customers.

Discussion with the Prudential Regulation Authority and the FCA Panels

56. We have discussed our approach with the PRA and the FCA Panels.

Contextual considerations

57. We have also considered the market context in which the rule would be introduced, looking at the following points.

- *The potential scale of detriment in the market:* as noted earlier, we expect the amount of CoCos in the market to increase rapidly in the coming years. Left unchecked, there is significant potential for these to be sold to ordinary retail investors who may suffer substantial detriment in the future.
- *The potential scale of detriment to individual customers:* we are concerned that securities offered by banks that offer higher rates of return will be particularly attractive to clients with most of their net wealth held in deposits. These clients may invest high proportions of their money into the instruments and, as a result, could lose substantial amounts in the event that an instrument triggers.
- *The social context:* we consider the type of ordinary retail investor most at risk of detriment to be people in retirement, who have built up substantial amounts of money in savings accounts but who are now searching for better interest rates than are available on cash accounts. These consumers may well be attracted by the high headline rates of return and may be vulnerable to marketing material promoting the investments on an unadvised basis, without understanding the additional risks they

would face. As a result, they may invest a significant proportion of their money in the instruments of one or a small number of issuers.

- *The market context:* as explained above, we are particularly concerned about the potential for behavioural biases to drive unsuitable sales in this market. We regard information asymmetries to be so pronounced and so difficult to eradicate that we do not believe alternative approaches, such as requirements for enhanced disclosure, more disclosure or for all sales to be advised would be sufficient to avoid detriment.
- *Possible unintended consequences:* we do not consider it likely that the introduction of the restrictions will have unintended consequences for capital raising. To date, our supervisory approach has provided protections for ordinary retail investors without damaging the ability of issuers to raise capital. We therefore do not expect there to be substantial numbers of existing ordinary retail investors with exposure to CoCos. CoCos may still be sold to investors for whom they are more likely to be suitable, including professional investors or retail investors who are high net worth or sophisticated. The rules are drafted in such a way that an ordinary retail investor who does hold a CoCo may still receive advice from a regulated firm about whether the investment remains suitable or should be reinvested. The rules prevent further investment by ordinary retail investors; they do not stop firms helping customers understand whether or not existing investments are suitable.

Compatibility with the FCA's regulatory principles

58. We have set out below why we believe our rules are compatible with our strategic objective, advance one or more of our operational objectives, and how we have regard to the regulatory principles in section 3B of FSMA. We have also considered whether the rules will have a significantly different impact on mutual societies as opposed to other authorised persons.

The need to use our resources in the most efficient and economic way

59. The temporary product intervention rules will limit the retail distribution of complex and risky securities to unsophisticated retail clients of ordinary means, who are at the greatest risk of being mis-sold these securities, and thereby suffering consequential potential detriment. The use of rules to achieve this is more resource-efficient than the current case-by-case supervisory approach.

Proportionality of burdens or restrictions imposed on persons or on carrying on an activity

60. We consider that the benefits of the temporary product intervention rules are proportionate; they protect ordinary retail investors but preserve firms' ability to promote these securities to professional, high net worth or sophisticated investors, for whom the securities are more likely to be appropriate.
61. The consultation paper setting out our proposals for permanent rules will include a detailed cost benefit analysis. This will be published before the implementation of the temporary product intervention rules.

The desirability of sustainable growth in the economy of the UK in the medium or long term

62. The temporary rules do not stop firms from using CoCos to raise capital but simply align retail distribution with the type of consumer most likely to be able to understand the risks and be able to afford potential capital loss.

The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons

63. We recognise that firms selling these securities to institutional investors, high net worth or sophisticated retail investors should be treated differently to those dealing with ordinary retail investors and the rules we are introducing aim to do this, providing appropriate flexibility.

The responsibilities of senior management

64. To ensure compliance with restrictions, we include a focus on senior management responsibility in the requirement for compliance directors to certify that the promotion complies with the relevant restrictions. If we find systematic failures in a firm in the future, we will be able to take enforcement action against senior management, if appropriate.

The desirability of publishing information relating to persons

65. We do not consider that the rules will have an impact on this.

The principle that we should exercise of our functions as transparently as possible

66. We have been transparent over our intention to intervene in this market. We announced our plan to consult on marketing restrictions for CoCos in FCA PS13/3, published in June 2013. We noted that we may make a temporary product intervention rule while we work on permanent rules.
67. Furthermore, we are announcing the use of the temporary product intervention rules in advance of their implementation. This will provide firms with time to update relevant systems and controls.

The general principle that consumers should take responsibility for their decisions

68. Consumers can only be expected to take responsibility for their investment decisions where they are in a position to understand the investments they are offered and the risks to which their money will be exposed. We believe ordinary retail investors are unlikely to be in a position to properly evaluate the risks and pricing of CoCos.

Expected effect on mutual societies

69. In performing our regulatory activities, we must always consider the impact of new rules on mutual societies.

70. A particular challenge for mutual societies is that mutuality precludes raising capital by way of issuing ordinary shares. This can lead mutual societies to issue alternative instruments, such as CoCos, and there have been recent issues of CoCos by building societies. Rather than convert to ordinary shares on a trigger event, these instruments would convert to other types of equity instrument issuable by mutual societies, or instead be written down.
71. The risks that these instruments present to ordinary retail investors are high and 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. The temporary product intervention rules will, therefore, apply to such instruments issued by mutual societies as well as to those issued by other entities such as banks.
72. We do not expect the temporary rules to have a significantly different impact on issues of CoCos by mutual societies as compared to other types of credit institutions. The high minimum denominations of existing issues should mean that ordinary retail investors are unlikely to hold these instruments. Our rules still allow for distribution to non-retail clients, sophisticated retail clients and high net worth retail clients.

Legislative and Regulatory Reform Act 2006 (LRRRA)

73. We are required under the Legislative and Regulatory Reform Act 2006 (LRRRA) to have regard to the principles in the LRRRA and to the Regulators' Compliance Code when determining general policies and principles and giving general guidance (but not when exercising other legislative functions). We consider that our proposal is:
- *Transparent*: as set out above.
 - *Accountable*: in making the restrictions as temporary product intervention rules, we are making use of a power granted to the FCA in the Financial Services Act 2012 and we are following the process set out in the policy statement on the use of temporary product intervention rules. We will use the future consultation paper to seek feedback on whether to make the rules permanent. The temporary product intervention rule will last for a maximum of 12 months.
 - *Proportionate*: as set out above.
 - *Consistent*: our approach would apply in a consistent manner to all firms considering sales of CoCos to retail clients.
 - *Targeted only at cases in which action is needed*: we consider there is significant need for the introduction of these measures.

Annex 2: Temporary product intervention rules

TEMPORARY MARKETING RESTRICTION (CONTINGENT CONVERTIBLE SECURITIES) INSTRUMENT 2014

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”):
- (a) section 137A (General rule-making power);
 - (b) section 137D (Product intervention rules);
 - (c) section 137T (General supplementary powers); and
 - (d) section 138M (Temporary product intervention rules).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on 1 October 2014 and will cease to have effect 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 Temporary Marketing Restriction (Contingent Convertible Securities) Instrument 2014.

By order of the Board of the Financial Conduct Authority

24 July 2014

Annex A

Amendments to the Glossary of definitions

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

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, if 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 or more common equity Tier 1 instruments;

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)

After COBS 4.13 insert the following new section. The text is not underlined.

4.14 Temporary product intervention rules

Temporary restriction on contingent convertible instruments

- 4.14.1 R (1) A *firm* must not
- (a) sell a *contingent convertible instrument* to a *retail client* in the *EEA*; or
 - (b) do anything that would or might result in the *buying* of a *contingent convertible instrument* or the holding of a beneficial interest in a *contingent convertible instruments* by a *retail client* in the *EEA*.
- (2) The prohibition in (1) does not apply if the *firm* has taken reasonable steps to ensure that one or more of the exemptions in *COBS* 4.14.2R applies.
- (3) In this section a *retail client* of the *firm* includes a *person* who would be a *retail client* if he were receiving services from the *firm* in the course of carrying on a *regulated activity*.
- (4) The rules in this section cease to have effect on 1 October 2015.

Exemptions

4.14.2 R	Title	Type of retail client	Additional conditions
	Certified high net worth investors	An individual who meets the requirements set out in <i>COBS</i> 4.12.6R, or a <i>person</i> (or <i>persons</i>) legally empowered to make investment decisions on behalf of such individual.	The <i>firm</i> must consider the <i>contingent convertible instrument</i> is likely to be suitable for that individual, based on a preliminary assessment of that individual's profile and objectives. (See <i>COBS</i> 4.12.5G(2).)
	Exempt persons	An exempt <i>person</i> (other than a <i>person</i> exempted only by section 39 of the <i>Act</i> (Exemption of appointed representatives)) if the activity relates to a <i>regulated activity</i> in respect of which the <i>person</i> is exempt from the <i>general prohibition</i> .	Not applicable.

Certified sophisticated investors	An individual who meets the requirements set out in <i>COBS 4.12.7R</i> , including an individual 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> .	Not applicable.
Self-certified sophisticated investors	An individual who meets the requirements set out in <i>COBS 4.12.8R</i> , including an individual 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> .	The <i>firm</i> must consider the <i>contingent convertible instrument</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> .	The prohibition does not apply provided all of the following requirements are met: (a) there is no <i>financial promotion</i> other than a <i>personal recommendation</i> on the <i>contingent convertible instrument</i> ; (b) the <i>personal recommendation</i> is made following a specific request by that <i>client</i> for advice on the merits of investing in the <i>contingent convertible instrument</i> ; and (c) the <i>client</i> has not previously received a <i>financial promotion</i> or any other communication 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 investment in <i>contingent convertible instruments</i> . (See Note 1.)
<i>MiFID</i> or equivalent third country business other than <i>financial</i>	Any <i>retail client</i> .	If the prohibited activities amount to <i>MiFID</i> or equivalent third country business, that rule only applies to the extent that the prohibited activity is the

<i>promotions</i>		<i>communication or approval of a financial promotion.</i>
Prospectus	<i>Any retail client.</i>	The prohibition does not apply to the distribution of a prospectus required under the <i>Prospectus Directive</i> .
Issuers	<i>Any retail client.</i>	To the extent that the <i>firm</i> is acting as issuer of a <i>contingent convertible instrument</i> , the prohibition only applies to the original issuance of the <i>contingent convertible instrument</i> and not to subsequent trading in the secondary market.
Clearing, custodial and processing services	<i>Any retail client.</i>	The prohibition does not apply to the extent that the <i>firm's</i> activities relate to clearing, registration or settlement of transactions in <i>contingent convertible instruments</i> (or rights to or interests in such instruments), any back office processing or reporting of such transactions, or custody of <i>contingent convertible instruments</i> .
Indirect investment	<i>Any retail client.</i>	The prohibition does not apply in relation to a beneficial interest in a <i>contingent convertible instrument</i> held from participation in a <i>regulated collective investment scheme</i> , investment in a <i>non-mainstream pooled investment</i> , or membership of an <i>occupational pension scheme</i> .
Note 1	<i>A person</i> is connected with a <i>firm</i> if it acts as an <i>introducer or 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 rules and guidance to contingent convertible instruments

- 4.14.3 R (1) For the purposes of compliance with this section and with any assessments or certifications required by the exemptions set out in *COBS 4.14.2R*, any references in *COBS 4.12* provisions to *non-mainstream pooled investments* must be read as though they are references to *contingent convertible instruments*.
- (2) If the *firm* is relying on the high net worth investor exemption, the sophisticated investor exemption or the self-certified sophisticated investor exemption for the purposes of compliance with *COBS 4.14.1R*, the statement the investor must sign should have references to *non-mainstream pooled investments* replaced with references to *contingent convertible instruments*.
- (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 *COBS 4.14.1R*.
- 4.14.4 R If a *firm communicates* or *approves* an invitation or inducement to acquire or underwrite a *contingent convertible instrument* (or rights to interests in that instrument) which is addressed to, or disseminated in such a way that it is likely to be received by, a *retail client*, it must comply with the record-keeping requirements in *COBS 4.11.1R*, adapted as follows:
- (1) references to *non-mainstream pooled investments* should be read as references to *contingent convertible instruments*; and
- (2) references to *COBS 4.12.3R* should be read as references to *COBS 4.14.1R*.