

Telephone: 020 7066 9346
Email: enquiries@fs-cp.org.uk

21 July 2021

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

Dear Sir / Madam,

Financial Services Consumer Panel response to HMT consultation on the Regulation of non-transferable debt securities (mini-bonds)

The Financial Services Consumer Panel (the Panel) is an independent statutory body. We represent the interests of individual and small business consumers in the development of policy and regulation of financial services in the UK.

We welcome the opportunity to respond to this consultation to improve the regulation of non-transferable debt securities (NTDS), or mini-bonds.

We consider it important that the overarching regulatory regime governing retail investments, including NTDS, provides a coherent approach to setting regulation that meets consumers' needs. We do not feel that investing is right for all consumers, but for those who do choose to engage in the market, we set out our vision for how the market should function in our [response to the FCA's call for input on consumer investments](#).

The foundation of this vision is firms having a duty to act in the best interests of their customers. This would make the firm responsible for the appropriate distribution of high-risk investments including the marketing, labelling and comparability of different investment options, as well as consumers' overall suitability for and understanding of the products which they invest in. This would create a market where:

- more of the population with investible assets, and where the decision is right for them, make an active and informed choice to invest, so maximising their own returns and supporting the real economy;
- the information disclosed to potential investors is designed in a way that will allow them to make effective decisions, and to compare the risks and rewards not only of different options for a given product type, but also of different products;
- it is not possible to use regulatory arbitrage to circumvent rules designed to protect consumers;
- there is a common industry-wide definition of consumer segments (such as 'high net worth', 'novice' or 'able to sustain losses'), which is used to inform product design, set purchasing channels, target marketing and ongoing engagement;
- the use of client self-certification must cease;
- information, education, guidance and advice is readily available and tailored to the consumer to ensure they are supported in taking decisions both pre-investment and on an ongoing basis. This will require the re-engineering of current thinking to better integrate these aspects together and blend them throughout the customer's investment life-cycle. Only in this way will trust be established and consumers supported through what is an inherently complex set of decisions;
- the use of guidance or advice should be the gateway to anything other than a range of default-based, simple, tax-efficient investments;

- products must be better designed, labelled and described to enable consumers to better understand fully the opportunities, risks and costs involved and easily compare these across options; and
- when harm does occur, there must be easily accessible and efficient redress and compensation solutions.

From the consumer perspective, the potential for harm in the NTDS market occurs for four main reasons:

- The investment opportunity may be fraudulent, or in some way misleading;
- The way that the promotional information is provided may make it hard for potential investors to understand risks and compare investment opportunities;
- The protections available to potential investors in mini-bonds differ depending on factors such as the route to market and whether they took financial advice, which may lead to confusion; and
- The definitions used to define a high net worth individual and the use of self-certification to determine if an investor is sophisticated may not provide adequate protection, resulting in investment by consumers who either do not understand the risks, or cannot afford to undertake the risks.

The Panel therefore supports the FCA's ban on the mass marketing of NTDS to retail investors (where the NTDS will be used to on-lend to or invest in third parties). We also support the Government's efforts to improve regulation in this market. However, we remain concerned that the proposals being considered do not fully address these potential harms. In particular, we are concerned about the exemptions in the Financial Promotions regime relating to self-certification and the definition of high net worth, which in our view, significantly weaken the regime's ability to protect consumers.

Our responses to the questions posed in the consultation are included at Annex A below.

Yours sincerely,

Wanda Goldwag
Chair, Financial Services Consumer Panel

Annex A – responses to questions

Q1. Do you consider that the issuance of NTDS, where the proceeds are then used to on-lend or invest in third party projects, have the characteristics of a financial services activity? Please explain your thinking.

Yes.

The issuance of NTDS in order to lend to or invest in third parties is a form of credit intermediation. Depending on the structure of the on-lending or investing, this activity can involve: maturity transformation; liquidity transformation; leverage; and credit risk transfer. Essentially therefore it is a form of shadow banking.

It is also extremely likely that most investors would perceive this as engaging in a financial services product, and therefore expect certain levels of regulation, protection and redress policies to apply.

Q2. What are the benefits and drawbacks of making the direct-to-market issuance of NTDS a regulated activity?

If the direct-to-market issuance of NTDS became a regulated activity, then any firm seeking to raise money through mini-bonds would have a choice between: either becoming an FCA regulated firm, and meeting the relevant Threshold Conditions; or alternatively to choose to appoint an FCA regulated intermediary (such as a crowdfunding platform) to issue their mini-bond, rather than doing it directly.

The Panel considers that the benefits of making direct-to-market issuance of NTDS a regulated activity would be that it potentially increases consumer protection by: providing better oversight of firms issuing NTDS; and better aligning the regulatory regime to investor expectations (a third of current and past mini-bond holders thought that mini-bonds were FCA regulated and therefore safe to invest¹).

In addition, by increasing the amount of regulatory oversight in this market, it will potentially allow the FCA to obtain better data and therefore to improve its understanding of how the market is operating and where potential problems might lie.

The potential drawbacks to making direct-to-market issuance of NTDS a regulated activity are that it might make it harder and more costly for firms to raise money through issuing NTDS, and that the time taken to raise money increases.

Further, it will not change the potential for harm that arises as a result of the exemptions to the regulations governing Financial Promotions, such as the use of self-certification. We believe that the use of self-certification must cease, and the burden be put on firms to determine whether their products are suitable for individual consumers.

It will also increase the FCA's regulatory burden, meaning that unless there is a commensurate increase in the FCA's resources, it may divert resources from other FCA activities.

We believe the potentially benefits clearly outweigh any potential drawbacks.

Q3. Do you agree that making the direct-to-market issuance of NTDS a regulated activity by providing a specific exception to Article 18 of the RAO is more

1

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/978557/Research_into_Non-Transferable_Debt_Securities.pdf p58

proportionate than bringing its issuance within the scope of the MiFID framework?

Yes.

Q4. Do you think that the provision of a prospectus would better inform retail investors when choosing whether to invest in NTDS? Please explain your thinking.

One of the problems with the existing regime covering NTDS is that there are no rules ensuring that the information provided to potential investors is presented in a consistent way that make it easy for consumers to understand potential risks. This will make it harder for investors to compare potential investments effectively and make informed decisions when trying to decide whether to and where to invest.

In addition, the background research accompanying this consultation provides clear examples of promotional material that was misleading.

The Panel considers that both these factors suggest that options that improve the accuracy and comparability of NTDS marketing materials provided to potential investors could help improve consumer outcomes, but this is contingent on these marketing materials being easy to understand and inform decision making – not too short to be only a summary and not so long (as is often the case with a prospectus) to make it difficult to understand and draw salient points from. The sole purpose of marketing materials should be to make clear to potential investors the risks and potential benefits of the particular mini bond. It should not therefore contain superfluous legal copy designed to suggest to consumers that they do not need to read the small print.

Q5. What are the benefits and drawbacks of extending the provision of the Prospectus Regulation to the issuance of NTDS?

Despite the fact that improving the accuracy and comparability of the marketing materials provided to potential investors in the NTDS market could help improve consumer outcomes, the Panel considers that it is not clear that using the Prospectus Regulation is the most effective way of achieving this. There are four main reasons for this:

1. As set out in paragraph 4.22 of this consultation, prospectuses are long and complex documents, and NTDS investors already struggle to absorb the information they are provided with. As such, the form and layout of prospectuses may not be one that will help consumers make effective decisions about whether or not to invest;
2. Lord Hill's [recent review](#) suggests the need for significant change to the UK's Listing regime. This has the potential to require changes to the regulation governing prospectuses. Therefore, the benefits of including the issuance of NTDS within the Prospectus regulations will depend on the impact of any changes that are made as a result of Lord Hills review. As such, it is not currently possible to assess whether this would represent a proportionate remedy compared to the potential for harm in the NTDS market;
3. The benefits, or otherwise, of including NTDS issuance within the Prospectus regulations will depend on the thresholds that are set for whether a NTDS issuer needs to produce a prospectus. If it is hoped that the inclusion of NTDS within the Prospectus Regulation regime will help consumers make better decisions, in part by making it easier to compare options, then it will be important that the majority of NTDS fall within the regime. In the transferable securities market, a prospectus is only needed where the amount of money raised will be more than €8 million over a 12-month period. However, as Figure 4 of the research accompanying this consultation shows, only around 20% of mini-bonds have a value of £5 million or more. This means that if the same rules were applied to NTDS as transferable securities, relatively few issuers would need to produce a prospectus. This will

reduce the potential value of having comparable reporting requirements. However, if a lower threshold is used, it will mean that borrowers in the NTDS market face a higher regulatory burden; and

4. It will also be costly for the FCA to provide the resources needed to approve potential prospectuses, resource that could be directed elsewhere to support consumers.

Q6. Do you consider that relying on existing FCA and HMT measures is sufficient, meaning that further regulation of non-transferable debt securities is not required?

No.

The Panel is supportive of the FCA's ban on the mass marketing of NTDS, and recognises that this will have had a substantial impact on reducing potential harm. We also support moves to strengthen the Financial Promotions regime.

However, the Panel remains concerned about the use of exemptions associated with the Financial Promotion rules. For example, the definitions used to define a high net worth individual and the use of self-certification to determine if an investor is sophisticated may not provide adequate protection, resulting in consumers investing in products when they either do not understand the risks, or cannot afford to undertake potential the risks and/or losses.

The Panel's concerns about the impact of self-certification are illustrated by the findings in Section 5.3.2 of the research that informed this consultation, which states:

"A few received cold calls from finance company's [sic] trying to sell a mini bond to them. One spoke of receiving a follow-up call from the provider when the online application form said she wasn't eligible for the mini bond; the caller told her to complete the form again and answer in such ways [sic] as to ensure it accepted her application. She has since lost £80,000 as the company went into administration."

In addition, the research supporting this consultation clearly indicates that a sizeable minority of investors in mini-bonds have not properly understood the product they are investing in.

These potential harms will not be addressed by existing measures.

Q7. Are there any other credible options that may better address concerns around the issuance of NTDS, whether instead of, or alongside, those considered here?

The FCA is currently consulting on its proposals for a new Consumer Duty. The Panel supports the proposal that there should be a duty for firms to act in the best interests of consumers. We consider that it will be important to include the marketing, and where relevant issuance, of NTDS under any new Consumer Duty.

The Panel considers that it would be appropriate for the Government and the FCA to review the rules on Financial Promotions. We consider that it would be helpful to remove the exemptions associated with self-certification and to tighten the definitions of what constitutes a high net worth individual. Where product promotion is limited to certain cohorts of consumers, we believe the firm must be responsible and accountable for ensuring that the product is appropriate for the consumer, and should not rely on self-certification to achieve this.

We also consider that it would be sensible to look at the disclosure requirements associated with the marketing of NTDS and to consider whether these could be improved.

Finally, we do not see why there should be any urgency in the purchase of this type of higher risk investment. We would therefore support the implementation of a dual step investment journey, especially for a consumer's first investment (potentially after which the consumer knowledge can be assumed as being 'grandfathered'), giving the time for the consumer to reconsider their actions as observed in some foreign regulatory jurisdictions².

² The bank said [it] had neglected an internal rule requiring staff to confirm twice that customers aged 70 years or older were in good health and had a good grasp of its products before making any sales. - <https://fr.reuters.com/article/us-japan-post-bank-misconduct-elderly-idUSKCN1VY0GL>