

High-risk investments: Marketing speculative illiquid securities (including speculative mini-bonds) to retail investors

Consultation Paper

CP20/8***

June 2020

How to respond

We are asking for comments on this Consultation Paper (CP) by **1 October 2020**.

You can send them to us using the form on our website at: www.fca.org.uk/cp20-08-response-form

Telephone:

020 7066 4156

Email:

cp20-08@fca.org.uk

Please do not send us responses by post at this time.

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1 Summary

Why we are consulting

- 1.1** We are consulting on making our temporary rules on marketing certain high-risk investments permanent and extending them to some similar securities. We want to prevent harm to consumers from investing in complex, higher-risk products that they do not understand and are not suitable for them.
- 1.2** Our temporary product intervention (TPI) for speculative illiquid securities (SISs) came into effect on 1 January 2020 and lasts for 12 months. It restricts speculative mini-bonds and preference shares from being mass-marketed to retail investors. It also improves disclosure of key risks and costs to those certified high net worth and sophisticated retail investors who are still eligible to receive promotions for these types of securities.
- 1.3** We now propose to make the TPI permanent, with a small number of changes. These are generally based on feedback we have received since publishing the TPI.
- 1.4** We have also seen the harm posed by speculative mini-bonds start to migrate to certain listed bonds, which are currently excluded from the TPI. However, these listed bonds are not regularly traded and have similar features to SISs. We are therefore proposing to bring these listed bonds which are not regularly traded into the scope of the TPI rules.
- 1.5** When we published our TPI in November 2019, we said we would consider additional proposals to strengthen our broader financial promotions regime for high-risk investments (HRIs). We believe that any further changes should be based on the fullest possible evidence of harm and, linked to our Consumer Investments business priority which we launched in our 2020/21 Business Plan, we are keen to engage more widely on this issue and expect to publish a discussion paper inviting further views.
- 1.6** Making the TPI permanent is the first part of our thinking relating to HRIs and not the end of our work in this area.

Who this applies to

- 1.7** This document will be of particular interest to:
 - issuers of SISs, including issuers of listed bonds with similar features to SISs which are not regularly traded
 - investment-based crowdfunding (IBCF) platforms and other intermediaries offering or otherwise providing services in relation to SISs
 - authorised firms which approve financial promotions for unauthorised persons issuing SISs (s21 approvers)
 - trade bodies for the IBCF sector

- issuers and distributors of non-mainstream pooled investments (NMPIs), in relation to the proposals described in paragraphs 3.34 to 3.37

1.8 The proposals in this document will also interest:

- investment exchanges
- consumers and businesses investing or considering investing in SISs
- consumer organisations
- businesses which rely on funding from SISs in the form of on-lending or investment using the proceeds of the issue

Implications of EU Withdrawal

1.9 The UK left the EU on 31 January 2020 with a Withdrawal Agreement. It has entered a transition period which is due to operate until 31 December 2020. When the transition period ends, EEA firms which currently passport into the UK and wish to continue operating in the UK will be subject to the temporary permissions regime or the financial services contracts regime (which covers supervised run-off firms and contractual run-off firms). We intend that our rules will apply to those firms in the same way that they apply to other firms.

The wider context of this consultation

1.10 When we published our TPI in November 2019, we set out the case for introducing marketing restrictions for SISs, including speculative mini-bonds. We did this because of concerns that these products were being marketed widely, particularly online, despite being high risk and difficult for most retail investors to understand. We now have the same concerns about listed bonds with similar features to SISs that are not regularly traded, which are not currently subject to the TPI.

1.11 The proposals in this CP are designed to prevent harm to consumers from investing in complex, higher-risk products that they do not understand and are not suitable for them. Several cases have shown that investing in these types of securities can lead to unexpected and significant losses for retail investors.

1.12 A key driver of this harm was the mass-marketing of these types of product, particularly online, which uses promotions to entice retail consumers to invest on promises of high returns while downplaying risks and/or suggesting products are more secure or protected than is the case. These practices take advantage of salience bias, which induces investors to focus more on the high return of these securities, but to underestimate the associated risks. Alongside the TPI, we published guidance explaining some practical implications of our existing COBS 4 requirements for firms that approve financial promotions for unauthorised persons (the s21 approver guidance). Together, they were aimed at addressing this driver of harm.

1.13 Our concerns with SISs coincide with an increasing prevalence of other types of HRIs being marketed to consumers. As noted above, we are keen to engage more widely on this issue and expect to publish a discussion paper inviting further views.

- 1.14** We have recently consulted on proposals to undertake a consumer harm campaign to warn consumers of the dangers of HRIs over the next 5 years. It includes an initial campaign to help consumers make better-informed investment decisions. This new campaign will target consumers investing in high risk, high return, illiquid investments.

What we want to change

- 1.15** Our proposals seek to address the driver of harm we have identified above in relation to SISs on a permanent basis by:
- preventing the mass-marketing to retail investors of certain types of speculative investment which we have identified as not generally suitable for them
 - improving the disclosure of key risks and costs to the certified high net worth and (certified or self-certified) sophisticated retail investors who can still receive promotions for these types of investment
- 1.16** Details of the proposals we are consulting on are set out in Chapter 3.

Outcomes we are seeking

- 1.17** Our proposals aim to reduce the number of retail investors investing in SISs which they do not understand and are not suitable for them, so they do not suffer significant and unexpected losses. We also want to ensure that the limited number of retail investors for whom SISs may be suitable are able to make better informed decisions about whether to invest and, if so, how much they want to risk.
- 1.18** We are seeking to achieve this by preventing widespread consumer exposure to financial promotions for SISs, and by providing those consumers who can still receive promotions for SISs with better information on which to base an investment decision. These requirements already apply to speculative debentures and preference shares by virtue of our temporary intervention, but we need to consult to make the TPI rules permanent and to extend them to relevant listed bonds where we are seeing the same harm migrate to.
- 1.19** Our rules take effect subject to any relevant exemptions in the Financial Promotion Order (FPO). In view of that, we recognise that unauthorised issuers will still be able to communicate financial promotions relating to their products within the scope of relevant exemptions under the FPO, in particular to certified high net worth individuals and sophisticated investors. But, as set out in Chapter 2, we consider that the exemptions for promotions to certified high net worth individuals and sophisticated investors do not allow mass-marketing to the general public of specific investments, including SISs. We can and will act if we think firms are not correctly applying these exemptions, and as a result are in breach of s21 of the Financial Services and Markets Act 2000 (FSMA). Such cases are more visible following the TPI. This is because the TPI prevents promotions approved or communicated by authorised firms from being widely marketed, including over the internet.

Measuring success

- 1.20** We will evaluate the success of our proposals through our supervision of firms and other activities. We will look for:
- an absence of financial promotions for SISs which are openly available on websites and in other public places
 - a reduction in the number of complaints we receive about SISs which are about a) financial promotions which are openly available to retail customers when they should not be or b) non-compliant financial promotions
 - clear disclosure of key risks and costs to certified high net worth and sophisticated investors in financial promotions for SISs
- 1.21** We expect our proposals to result in fewer consumers investing in SISs. So, we would expect fewer retail investors to be affected by any future failure of, for example, a speculative mini-bond issuer.
- 1.22** We have tested the relative efficacy of disclosures of key risks in collaboration with Warwick Business School. [Online experiments](#) tested the TPI risk warning rigorously and provided robust evidence that it improves investors' comprehension of risks.

Next steps

What do you need to do next?

- 1.23** We want to know what you think of our proposals. Please send us your comments by 1 October 2020, using the online response form on our website or by emailing us at the address on page 2.

What will we do next?

- 1.24** We will consider your feedback and, subject to that feedback, propose to publish final rules in a Policy Statement before the end of 2020. Subject to any changes arising from consultation feedback, we intend that rules making the TPI permanent will come into effect on 1 January 2021, so that the measures currently applying continue as permanent rules, along with the additional changes proposed.
- 1.25** As noted above, in light of the increasing prevalence of other types of HRIs being marketed to consumers, and linked to our Consumer Investments business priority in this area, we are keen to engage with industry on wider issues and expect to publish a discussion paper inviting further views.

2 The wider context

Speculative illiquid securities (SISs)

- 2.1** The proposals in this CP are targeted at SISs. As we explained when we published our TPI, based on our work in this area, the features of these securities often include one or more of the following:
- they are usually issued by an unauthorised person who is not subject to FCA oversight, and will generally not be covered by the Financial Services Compensation Scheme (FSCS)
 - they are commonly issued through a special purpose vehicle (SPV)
 - they offer a high fixed rate of return (often 8% or more) to investors if they commit to invest for a fixed period (eg 3 or 5 years), with little or no opportunity to sell or transfer the investment before the end of that period
 - they involve an issuer using the capital raised to fund speculative and high-risk activities
 - they often involve high costs or third-party payments being made from the proceeds of the issuance
- 2.2** We consider SISs are high risk and opaque where an issuer uses some or all of the funds raised to on-lend to third parties, or to buy or acquire investments, or to buy or fund the construction of property. The risks associated with SISs are often similar to unauthorised collective investment schemes (UCIS), which are subject to similar restrictions to the TPI, as are other types of NMPIs. We consider that the complexity and risks of SISs mean that their promotions should be limited to a very niche retail market, where investors can understand the risks and bear potential losses.
- 2.3** We have purposefully sought to exclude companies that issue securities to fund ordinary business activity that is not highly speculative, but these securities will be subject to our other rules that currently apply to these instruments (eg as non-readily realisable securities (NRRSs)).
- 2.4** Before our TPI, there was widespread marketing of SISs, particularly via the internet, with financial promotions for these products commonly appearing in response to simple online searches for 'high investment returns' and similar phrases. We had significant concerns that increasing numbers of less sophisticated or less wealthy retail investors would be drawn to these products by promotions. These promotions focus on attractive 'headline' interest rates, while down-playing key risks and implying the products are more secure than they are in practice.
- 2.5** We were also concerned about mass-marketing which suggested that the FCA or HMRC offer protection or endorsement of these products, which is misleading. For example, some promotions claimed that an investment is eligible to be held in a tax-incentivised 'wrapper' (eg the Innovative Finance Individual Savings Account (IF ISA) or a self-invested personal pension (SIPP)) when it did not qualify. Where an investment was eligible to be held within the wrapper, the promotion sometimes misleadingly

implied that HMRC's role in overseeing a tax wrapper meant the investment was endorsed by Government.

- 2.6** Based on FCA data, our updated estimate is that upwards of 63,500 bondholders hold SISs with the average investment being £22,100 (updated FCA analysis of SISs prior to the introduction of the TPI). This would mean significant losses for individuals if an issuer failed and little or no money was repaid. This risk was sufficiently serious and immediate for us to introduce temporary product intervention rules without consultation. Significant consumer harm could arise if retail consumers invest without properly understanding the risks of these products, and later experience unexpected losses. In general, SISs are unlikely to be suitable investments for most retail consumers. However, we do not assume all SISs will fail.
- 2.7** For more information on why we intervened in the marketing of SISs see the [TPI statement we published in November 2019](#).
- 2.8** The focus of our concern around SISs was on debentures (including mini-bonds), which was where we were seeing the greatest harm. The TPI also extended to preference shares to close off an obvious route for arbitrage. We excluded products which fell into the Handbook definition of 'readily realisable securities', including securities admitted to official listing or regularly traded on relevant investment exchanges.
- 2.9** Since publishing the TPI, we have seen evidence that some UK-based issuers of speculative mini-bonds have gained admission to listing for bonds which are not regularly traded and are promoting them to retail investors (see Chapter 3 for further details). This leaves them out of scope of the TPI rules, despite the products involving similar complexity and risk as the mini-bonds caught by the TPI. To address this, as part of making the TPI rules permanent, we propose extending the rules to these bonds.
- 2.10** We recognise that there is scope for arbitrage if the TPI rules do not apply to other types of security with similar features to SISs. As noted above, we believe that any further changes should be based on the fullest possible evidence of harm and, linked to our Consumer Investments business priority which we launched in our 2020/21 Business Plan, we are keen to engage more widely on this issue.

The broader market and social context

- 2.11** Persistent low interest rates since the financial crisis make the high rates of fixed return advertised by SISs attractive to many retail investors, particularly those who typically keep most of their net wealth in deposits or low-risk bonds. This may include investors seeking a regular income from investments, such as retirees, who may have drawn down pension savings following the pension freedoms. These types of consumers may be tempted to invest a high proportion of their savings into SISs, especially if they take marketing at face value and do not understand the risks. The findings of our experiments in collaboration with Warwick Business School are consistent with this view – a sample of retail consumers, with on average low investment experience, are more likely to choose minibonds over less risky investment options. While this may reflect a genuine preference for a product, it may also suggest that consumers underestimate the investment risk associated with speculative mini-bonds because for all other investment products they are more likely to choose the safer investment choice.

- 2.12** Consumers could lose substantial amounts of their money if a product fails, and investors may struggle to replenish savings if they are no longer earning. The scale of this risk was revealed by, amongst others, the failures of London Capital & Finance (January 2019), Bassett & Gold and Blackmore Bond plc (both in April 2020). Across the 3 cases consumers lost approximately £300 million, which represents approximately 21% of the estimated outstanding amount in the SIS market in 2019 (£1.4 billion according to our analysis of online promotions). These events highlight the high risk of default for SISs and the potential for significant consumer harm. Such failures may become more common given the impact of coronavirus (Covid-19), and the harm further exacerbated by savers also looking for better rates of return.

The regulatory landscape

Overview

- 2.13** We have limited powers over unauthorised issuers of SISs. But we can act on the marketing of products when an authorised firm approves or communicates a financial promotion, or directly advises on or sells these products. We are actively investigating firms that appear to have breached our rules linked to promotions for, or the distribution of, SISs.
- 2.14** Further steps were necessary to protect consumers and reduce harm from the mass-marketing of SISs. So, through our TPI, we acted to strengthen our financial promotions rules on a temporary basis by:
- restricting the marketing of SISs to ensure they could only be promoted to individual retail investors who have been categorised in advance as either certified high net worth or sophisticated, and where the product has been initially assessed as likely to be suitable for them
 - mandating a specific risk warning and disclosures of any costs or payments to third parties that are deducted from the money raised by an issuer in any financial promotion for these products
- 2.15** Previously these types of product had generally been subject to our financial promotion rules for NRRSs in [COBS 4.7.7R](#), although in some instances the rules for NMPIs in [COBS 4.12](#) may have applied.
- 2.16** The TPI rules apply only to debentures and preference shares which are not readily realisable securities (as defined in our Handbook). Other types of share and securities admitted to official listing or regularly traded on a relevant exchange were not covered. The former are generally subject to the NRRS/NMPI rules (as applicable), while the latter are treated as 'readily realisable securities' in COBS 4.
- 2.17** The TPI rules apply to any relevant promotion approved or communicated by an authorised firm from 1 January 2020, and apply for 12 months. Authorised firms therefore need to ensure that financial promotions which they communicate or approve comply with these rules. To continue applying the TPI requirements after the end of this year, we need to make permanent rules, so we are consulting on the proposals in Chapter 3.

2.18 We recognise that unauthorised issuers may still promote certain investment opportunities to certified high net worth individuals or sophisticated investors by relying on exemptions under the FPO. We consider these exemptions allow relatively restricted marketing activity, preventing the mass marketing of specific investment opportunities to the general public. Instead, communications under these exemptions may only be made to individual investors who are certified sophisticated investors, or whom the person making the communication believes on reasonable grounds are certified high net worth individuals or self-certified sophisticated investors.

2.19 Unauthorised persons who communicate financial promotions outside the scope of an FPO exemption, and where the financial promotion is also not approved by an authorised firm, will be in breach of the financial promotion restriction in s21 of FSMA. This is a criminal offence, and carries potential liability of up to 2 years imprisonment, or a fine, or both. We can and will act on unauthorised business or illegal promotions where we see such cases.

The TPI requirements in detail

2.20 With effect from 1 January 2020, we introduced temporary measures in [COBS 4.14](#) lasting for 12 months.

- Firms are prohibited from approving or communicating any promotions for SISs addressed to or disseminated in such a way that is likely to be received by a retail client. However, there are exceptions for promotions to certified and self-certified sophisticated or certified high net worth retail investors and for certain excluded communications. Firms also need to carry out a preliminary assessment of the suitability of a SIS for any certified high net worth or self-certified sophisticated investor to whom it is marketed as explained in COBS 4.14.4G (eg considering a client's profile and investment objectives). This means that SISs are subject to similar marketing restrictions as apply to NMPIs.
- Any marketing material indicating benefits of those SISs must also include specific and prominent disclosure including:
 - a standardised risk warning, which clearly states that investors may lose all their money, that these products are high risk, and, where appropriate, ISA eligibility does not protect consumers from losing their money
 - costs and charges associated with the security, and any third-party payments made by the issuer that are deducted from the capital raised, which should be indicated as a percentage of the capital raised and illustrated as a cash sum
 - where applicable, the date on which the promotion was approved.

2.21 For the purposes of the TPI, SISs are defined as debentures or preference shares with a denomination of £100,000 or less that involve an issuer using some or all of the proceeds to lend money to third parties, buy or acquire investments, or buy or fund the construction of property (subject to certain property-related exemptions described in Chapter 3). Currently, securities which fall within the definition of 'readily realisable securities' in our Handbook (eg securities which are listed or regularly traded on a relevant exchange) are excluded.

2.22 The TPI requirements do not apply to a business raising debt or equity capital for its own purposes, or for a group entity, which fall outside of those activities listed above. We also excluded credit institutions. Finally, Peer-to-Peer agreements (which are subject to requirements in COBS 4.7.7R and COBS 18.12), and products that already fall within our NMPI definition, are not caught by the temporary rules.

How it links to our objectives

Consumer protection

- 2.23** Our proposals advance our consumer protection objective by seeking to reduce/prevent the harm to consumers from investing in complex, higher-risk products that they do not understand and are not suitable for them. We have seen, and continue to see, harm to retail investors arising from the inappropriate marketing and sale of SISs to less sophisticated or wealthy investors, and poor disclosure of key risks.
- 2.24** In addition to the failure of London Capital & Finance in 2019, there have been several other recent examples of issuers of SISs failing with consequent impacts on consumers, for example Bassett & Gold and Blackmore Bond plc (see paragraph 2.12 above).

Market integrity

- 2.25** Our proposals are also relevant to our integrity objective, as failures and unexpected losses for retail investors may undermine confidence in UK financial markets, impacting the soundness, stability and resilience of the UK financial system.

Competition

- 2.26** In terms of our competition objective and duty, we do not consider it to be in the interests of consumers for firms or businesses to compete to sell products to them that do not meet their needs, eg because they are complex, higher-risk, difficult to understand and are therefore unsuitable. Limiting access for most retail investors is an intended effect of making the TPI rules permanent. We have not identified an alternative approach that better promotes competition while ensuring appropriate consumer protection from the risk of harm posed to retail investors by these products. And since we consider the risks of SISs to be comparable to NMPIs, our measures help equalise the treatment of comparable products.
- 2.27** At the same time, we want to improve the disclosure of key risks and costs to those certified high net worth and sophisticated retail investors who are still eligible to receive promotions for these types of securities. This should help ensure that those investors are making better-informed choices when investing.

Wider effects of this consultation

- 2.28** We expect our proposals to reduce the number of retail investors who invest in SISs which are not suitable for them. We are aware that there may be an increase in businesses seeking funding as a result of coronavirus (Covid-19). Making the TPI rules permanent will reduce a source of funding to some businesses. This is more likely for smaller businesses that have novel business models or seek to intermediate lending to individuals and businesses. However, we do not think that there is an alternative approach that would provide appropriate investor protection.
- 2.29** Overall, reduced investment in SISs should mean that investors' savings are more likely to be invested in other investments which may be more suitable for consumers, generating a return in exchange for a level of risk that retail consumers can better understand and bear.

Unintended consequences of our intervention

- 2.30** Existing investors may be affected if our measures have negative effects on existing issuers, who may find it more difficult to raise new funds (although our measures do still allow SISs to be marketed to 'eligible' retail investors). Investors may also try to exit their investments early, where this is possible under the terms of the security. If an issuer of SISs is already in financial difficulty, our rules could exacerbate the risk they are unable to make future interest payments or repay investors' capital, even if this is ultimately caused by weakness in the investment proposition. For example, if an issuer is heavily reliant on new capital raising to be able to repay existing investors, it may suggest the product or business model was already unsustainable and likely to lead to losses. To date, we have not seen any evidence of this happening because of the TPI.
- 2.31** We consider on balance the overall consumer protection benefits of our measures outweigh the short-term risk that losses are brought forward for some investors. This is because our measures should significantly restrict future levels of investment in SISs by consumers for whom they are unlikely to be suitable. It also makes it less likely that unsustainable issuers can raise more capital over time, risking larger future losses to investors. Our measures also protect market integrity, as failures and unexpected losses for retail investors linked to persistent, widespread and poor marketing of these products may undermine confidence in UK financial markets, impacting the soundness, stability and resilience of the UK financial system.
- 2.32** Although our measures may also affect better performing issuers of SISs, we consider these issuers are more likely to still be able to attract eligible investors under the new restrictions based on a stronger track record, or they could seek other sources of finance (for example, from professional investors). In addition, even if an issuer's securities have been better performing in the past, they remain high risk and complex. So, they will still pose a risk of future losses for investors, and are unlikely to be suitable for most retail investors.
- 2.33** We consider it highly unlikely that there will be many, if any, retail investors for whom SISs could be suitable.
- 2.34** There is a possibility of retail investors who seek high returns turning to other investments with similar features which are not subject to our proposed rules. As noted above, we believe that any further changes in this area should be based on the fullest possible evidence of harm and, linked to our Consumer Investments business priority which we launched in our 2020/21 Business Plan, we are keen to engage more widely on this issue.
- 2.35** We note that authorised firms communicating or approving a financial promotion can approach us to apply for a waiver if they think complying with our rules would be unduly burdensome or not achieve its purpose, and would not adversely affect the advancement of any of our operational objectives (s138A of FSMA). We will then consider whether a waiver is justified based on the merits of an application against the statutory tests. Unauthorised issuers promoting their securities through, or with the approval of, an authorised firm would need to rely on that authorised firm to seek a waiver, since our rules (and any waivers) apply only to authorised firms.

What we are doing

2.36 Our proposals for consultation are described in detail in Chapter 3. In summary, we are proposing to:

- make the TPI rules permanent for debentures and preference shares which are currently subject to them (subject to certain changes addressed below)
- expand the scope of the TPI rules so that they apply to any listed bonds with similar features to SISs which are not regularly traded
- exclude certain securities from the TPI rules where they relate to single-company investments
- make certain clarifications to the TPI rules, including so that the existing exemptions operate as intended
- clarify how promotions are restricted for SISs and NMPIs

Box 1. Our use of the 'design thinking' process

Design thinking is an approach to policy-making that ensures the consumer is kept front of mind. It blends consumer research with behavioural insights and data analysis to arrive at policies that deliver in the interests of consumers. Design thinking is increasingly used in policy-making institutions, including the FCA.

Whilst exploring the efficacy of the TPI we used the design thinking process to understand the consumer experience of purchasing SISs and to consider how we could change that experience to remedy the risk of harm.

We used evidence from the wider work referred to in paragraph 3.8 to better understand: the type of consumers purchasing these products, the consumer journey to purchasing these products and why features of the product advertising were causing consumers harm. This approach informed our view of the key features of these products, as set out in paragraph 3.11.

One output from design thinking is the consumer journey map. The consumer journey map represents the typical steps that a consumer must take to purchase a product and we used this to understand suitable intervention points to prevent harm from occurring. In addition to setting out the consumer journey, we also reviewed data and evidence to better establish the range of consumers that were purchasing SISs.

The design thinking process helped us to identify the drivers of harm which we aimed to address: consumers were generally unaware of the risks the products involve, misleading marketing that focussed on the potential rewards without highlighting the associated risks, and the process of investing did not provide adequate time for consumer reflection.

The design thinking approach, coupled with consumer testing of risk warnings (see paragraphs 3.16 and 3.17), ensures we've kept consumers at the heart of our policy response.

Equality and diversity considerations

- 2.37** We have considered the equality and diversity issues that may arise from the proposals in this CP.
- 2.38** Overall, we do not consider that the proposals materially impact any of the groups with protected characteristics under the Equality Act 2010. But we will continue to consider the equality and diversity implications of the proposals during the consultation period, and will revisit them when making the final rules.
- 2.39** We expect that our proposals are generally likely to be of greater significance to consumers with higher incomes or a reasonable level of savings, since promotions for SISs are often targeted at these types of investor. Those with larger levels of savings are typically slightly older, while YouGov survey data also suggests a slightly higher proportion of existing investors in HRIs are male versus female. However, our remedies should operate to protect any person who is looking to invest, irrespective of age and gender.
- 2.40** In the meantime, we welcome your input to this consultation on this.

3 Making the TPI rules permanent

Introduction

- 3.1** This Chapter outlines our proposals to make permanent rules restricting the mass-marketing of SISs to retail investors. The rules will apply to authorised firms approving or communicating financial promotions for such investments. This includes EEA firms currently passporting into the UK which enter the temporary permissions regime or the financial services contracts regime. We are proposing that the new rules will come into force on 1 January 2021 so the requirements of the TPI are maintained.
- 3.2** While the nature of the proposed marketing restriction is broadly consistent with what we applied under the TPI, we also propose to bring into scope listed bonds with similar features to SISs which are not regularly traded.
- 3.3** We also propose further clarifications to scope and other aspects of the temporary rules, which are designed to:
- provide an additional exemption for products where we consider this is consistent with the original intention of the TPI
 - ensure the exemptions provided for in the temporary rules operate as intended
 - clarify certain other aspects of the temporary rules
 - clarify how promotions should be made to, or directed at, investors under these rules, and the rules that apply to the marketing of NMPIs in COBS 4.12

Speculative illiquid securities

Context for our intervention

London Capital & Finance (LCF)

- 3.4** LCF was an issuer of so-called 'mini-bonds'. It stated it used the proceeds to make loans to corporate borrowers to provide capital for further investment. LCF issued mini-bonds to 11,625 investors, with a value of £237.2m. On 30 January 2019, LCF appointed administrators after the company was assessed to be insolvent. We had previously intervened to ban misleading promotions issued by LCF. Criminal investigations in relation to LCF are ongoing. See our website for more information about the administration of LCF.
- 3.5** The Treasury subsequently directed the FCA to begin an independent investigation into the circumstances surrounding the collapse of LCF and our supervision of the firm in May 2019. In addition, the Treasury launched its own review of the wider policy questions raised by the case of LCF.
- #### *Further work on conduct issues relating to SISs*
- 3.6** Before making the TPI, we looked at risks posed by the promotion of SISs, both before and after LCF. Our work has focused on FCA-authorised firms involved in approving

promotions (under s21 of FSMA), or promoting or distributing SISs themselves. We have examined whether financial promotions approved or communicated by firms comply with our rules. We have also identified conduct issues with some firms that provide advice, portfolio management or arranging or dealing services in relation to these products.

3.7 We also examined promotions for SISs issued by unauthorised persons claiming to rely on an exemption in the FPO to consider whether they have done so correctly, or are breaching the financial promotion restriction.

3.8 Overall, our wider work has included the following.

- We are currently examining the practices of 78 firms involved in the distribution of mini-bonds, and reviewing the due diligence undertaken by s21 approvers when approving financial promotions for communication by unauthorised persons. Since April 2019, we have also assessed over 550 financial promotions that may not have complied with our rules.
- Reviewing 272 cases where marketing activities relating to SISs may have breached the financial promotion restriction.
- Applying an enhanced assessment to new applicants seeking FCA authorisation or existing firms seeking to vary permissions where they indicate a business model that relates to offering or promoting SISs or other high-risk investments. Since December 2019, this has included checking firms' compliance with the requirements of the TPI.

3.9 Where we see breaches or failures of our requirements, we have a range of tools we can use. For example, we can ban adverts, seek voluntary requirements from s21 approvers which prevent them from undertaking this activity again, and we can issue alerts to consumers warning them about specific unauthorised firms. We are also pursuing a number of enforcement investigations in relation to the promotion of SISs by particular firms and individuals.

3.10 We have been proactively monitoring, and assertively supervising compliance with the TPI rules. We have not seen a large number of promotions breaching the TPI, with the vast majority of firms appearing to have made the necessary changes to financial promotions to be compliant by 1 January 2020. Where we have seen breaches, we have taken swift action to get the financial promotion removed or amended.

The nature of the products we are concerned with

3.11 The key features of the SISs we have seen include:

- the promise of high annual returns, often presented as 'fixed', often starting at 6-8% – well above rates offered by traditional cash-savings products (FCA analysis of a sample of 270 SISs marketed online showed that 81% had a coupon rate equal to or higher than 6%)
- exposure to high-risk, speculative assets that are difficult for an investor to value or verify, and which present a mismatch to the implied 'security' of returns and capital repayment
- an unauthorised issuer, or an issuer that is authorised but where the issuing of securities is unregulated, which usually means there is no FSCS protection
- complex legal structure to a product, or between a promoter and issuer
- high upfront or embedded costs and charges
- lack of an effective secondary market

- often misleading financial promotions that:
 - focus on attractive headline returns
 - imply capital protection or other features (diversification, asset-backed) as reducing risk, which may not be effective protections in practice
 - do not disclose costs and charges to the investor or embed them in the arranging or structuring of the product, with fees of 20% or more of funds raised in some cases (undermining the likelihood of being able to deliver advertised rates of return)
 - use the 'approving' role of an FCA-authorized firm, or the fact the issuer or distributor is authorised for certain activities, to imply regulatory protection or FCA endorsement of a product
 - advertise that the investment is eligible to be held in a tax-incentivised 'wrapper' (eg an IF ISA or SIPP) when it does not meet the qualifying criteria
 - use the role of HMRC in overseeing tax wrappers (eg IF ISAs or SIPPs) to imply oversight or endorsement by the Government

3.12 The risks associated with SISs are often similar to UCIS which are subject to similar restrictions to the TPI, as are other types of NMPIs. The likelihood of investors receiving interest and capital repayment often depends on an issuer achieving pooled returns from lending to, or investing in, other third parties or property, usually involving a high degree of speculation and risk. Significant costs and charges or third-party payments deducted from the amounts raised by an issuer also makes the feasibility of achieving promised returns even more challenging. We do not think most retail investors can easily understand or assess such risks.

Drivers of harm and the interaction with our rules

3.13 We continue to believe there is a significant risk of consumer harm from unsuitable retail investment in SISs which would arise from:

- the open, mass-marketing of these products focusing on the high returns on offer, while understating the risks involved, and targeting consumers for whom these products are unlikely to be suitable
- insufficient risk warnings and a lack of transparency around fees being deducted from the proceeds raised in the issuance, which may impact the prospects of investors receiving interest payments or capital repayments

3.14 The existing TPI rules address the drivers of harm, for the products currently subject to them, so we propose to make them permanent with some amendments. We also propose extending the TPI requirements to listed bonds with similar features to SISs which are not regularly traded, as this is where we are seeing the harm start to migrate.

Making the temporary rules permanent

3.15 We are proposing to make permanent the current marketing restriction for debentures and preference shares currently subject to the TPI where an issuer uses the proceeds to lend money to third parties, buy or acquire investments, or buy or fund the construction of property (subject to certain exemptions). As set out in the original TPI statement, the permanent measures will require the following.

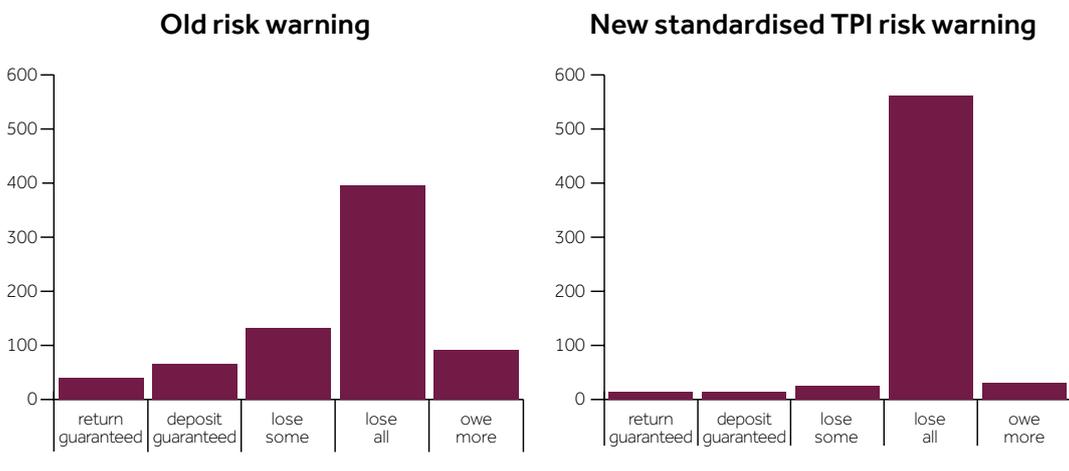
- Any promotions for SISs directed to or likely to be received by a retail client must be restricted to sophisticated or certified high net worth retail investors. Firms will also need to carry out a preliminary assessment of the suitability of a security for any certified high net worth or self-certified sophisticated investor to whom it is marketed (eg considering a client’s profile and investment objectives). This ensures SISs are subject to similar marketing restrictions as currently apply to NMPs.
- Any marketing material indicating benefits of SISs must also include specific and prominent disclosure including:
 - a standardised risk warning, which clearly states that investors may lose all their money, that these products are high risk, and, where appropriate, ISA eligibility does not protect consumers from losing their money
 - costs and charges associated with the security, and any third-party payments made by the issuer that are deducted from the capital raised, which should be indicated as a percentage of the capital raised and illustrated as a cash sum
 - the date on which the promotion was approved.

3.16 Academic evidence from trials run with Warwick Business School shows that the new risk warning mandated under the TPI improves investors’ comprehension of risks of investing in mini-bonds. Further details on the two online experiments that tested the relative effect of the new TPI risk warning compared to an older, ‘capital at risk’ style risk warning are included in our [Research Note](#) published today.

3.17 The first online experiment found that participants were more likely to choose speculative mini-bonds than Stocks and Shares ISAs. While this may reflect a genuine preference for a product, it may also suggest that consumers underestimate the investment risk associated with mini-bonds because for all other product types they are more likely to choose the safer investment choice. In the second online experiment, the TPI risk warning had a positive effect on consumer comprehension of investment risk, relative to an old-style risk warning, with the largest effect for mini-bonds.

Box.2 Relative effect of the standardised risk warning

The FCA’s Behavioural Economics and Design Unit collaborated with Warwick Business School to run two online experiments, using participants selected from a panel provider (Prolific.ac) who were representative of typical retail investors. Under the TPI risk warning, participants were more likely to identify mini-bonds with the risk of ‘losing all’ money invested, compared to when an older ‘capital-at-risk’ style risk warning was applied.



The charts show that the number of participants correctly identifying a mini-bond as associated with the risk of 'losing all' money invested increased when using the new risk warning.

Under the TPI rules, risk warnings will be shown on promotions that can only be advertised to people who are certified high net worth or sophisticated investors where a preliminary suitability assessment has been carried out. Our experimental sample was representative of UK retail consumers with on average low investment experience and only a small number of participants had professional investment experience (eg IFAs/ex-IFAs). Whilst we assume that the effect of the risk warning may be larger for this group on average, we expect that the new risk warning still has a positive effect on the comprehension of risk for the population of high net worth and sophisticated investors.

3.18 Consistent with the TPI rules, we are also retaining certain exemptions relating to issues of securities used to purchase or develop property which these marketing restrictions will not apply to (subject to the proposed changes described in paragraph 3.32 below).

- Securities issued by companies to purchase property or pay for the construction of property where the relevant property will be used by the company (or a group company) for a general commercial or industrial purpose. We exclude from this exemption cases where an issuers' ability to pay interest or repay capital to investors is wholly or predominantly linked to, contingent on, highly sensitive to or dependent on the return generated from the purchase or construction of the property; in other words, speculative property investments. We also exclude property development and the provision of construction services from being general commercial purposes.
- Products involving a single UK property or properties within a single development in the UK, purchased via a holding company and providing a return based on the rental income and any capital appreciation of the property. A property would need to be income-generating, and the issuer's activities need to be limited to preclude property development activities. These products do not give discretion to an issuer in how investors' funds are used, and appear less complex for retail investors to understand.

3.19 Such investments are, however, likely to be subject to our rules for NRRSs already.

Q1: Do you agree with our proposal to make the TPI requirements permanent? If not, please give reasons.

Expanding scope to listed bonds which are not regularly traded

3.20 When making our temporary rules, we decided to exclude 'readily realisable securities', which includes securities:

- admitted to official listing on an exchange in an EEA State, or
- regularly traded on or under the rules of such an exchange, or
- regularly traded on or under the rules of a recognised investment exchange or (except in relation to unsolicited real time financial promotions) designated investment exchange

3.21 We did so on the basis that admission to listing will typically coincide with admission to trading and production of an approved prospectus, and provides the prospect

of a potential secondary market in securities. At the time, we felt the scrutiny and transparency of a prospectus, in particular, would reduce the risk that securities, with similar risks to SISs, would be admitted to listing or trading and be widely promoted to retail investors.

- 3.22** Since our TPI, we have become aware of a larger number of UK-based issuers that have speculative bonds admitted to listing or trading on exchanges, primarily elsewhere in the EEA. Often these are the same companies that have previously issued speculative debentures that were not admitted to listing or trading. These bonds are similarly directed to UK retail investors, are similarly complex and pose similar risks. In some cases, speculative *listed* securities may pose greater risks since issuers raise larger amounts with longer maturities. Issuers have also encouraged holders of previously unlisted SISs to roll over into a listed security that serves to re-finance the same venture and avoids our temporary rules restricting their marketing.
- 3.23** Admission to listing or trading may also be used in promotions for such securities to infer greater security and the prospect of a secondary market, although in practice there is still little or no liquidity. This may further mislead retail investors as to the risks involved, particularly in their ability to exit their investment before maturity. It is important to note that in the absence of listing, the definition of readily realisable security requires a relevant security to be 'regularly traded' on a relevant exchange. For this purpose, we would not consider wash-trading, circular trading or any other form of contrivance to constitute regular trading. Any trading carried out to give false or misleading signals as to the supply/demand of a financial instrument is one of the forms of market manipulation as defined, and prohibited, by the Market Abuse Regulation. It may also amount to a misleading impression under section 90 of the Financial Services Act 2012, which is a criminal offence carrying a penalty of up to 7 years imprisonment and an unlimited fine. Any issuer or connected person who seeks to circumvent the TPI rules in this way is liable to be prosecuted for those offences particularly in circumstances where harm has impacted UK consumers.
- 3.24** We have identified over 40 UK-based issuers of debt securities that appear akin to SISs that were either recently or are currently listed or traded on on (mainly non-UK) EEA exchanges or venues, which we think have been predominantly promoted and issued to UK retail investors. Some have de-listed, often due to failing to provide accounts, or due to an issuer entering liquidation. In practice, some issuers have migrated to readily realisable securities which are not subject to the TPI rules, and to the extent these are openly and widely promoted to UK retail investors, they are posing similar risks of harm to SISs subject to the TPI.
- 3.25** We consider that the TPI rules should also extend to bonds admitted to listing or trading where the bonds have the same speculative features as SISs and are not regularly traded, to prevent regulatory arbitrage. Exchange traded bonds which are not regularly traded are not within the definition of a readily realisable security and are therefore subject to the TPI rules. We propose to also bring listed bonds which are not regularly traded into the scope of the TPI rules. In accordance with what we said in [CP19/33: Quarterly Consultation No 26](#), for the purposes of the permanent rules we are proposing to adopt the Handbook definition of 'readily realisable security' which will apply from the end of the EU withdrawal transition period (IP completion day) which retains a reference to 'EEA state'. As a result, the proposal to bring listed bonds into scope will also apply to bonds which are listed on an EEA exchange but not regularly traded.

- 3.26** The intention of this proposal is to capture a specific type of bond posing particular risks to retail investors as described above. If we receive evidence from consultation responses that other types of bond may be inadvertently caught, we may adjust the proposals accordingly.
- 3.27** The exemption in Article 70 of the FPO will continue to apply to non-real time communications included in relevant prospectuses, listing particulars and certain other documents where applicable (but not advertisements within the meaning of the Prospectus Regulation).

Q2: Do you agree with our proposal to expand the scope of the TPI rules to listed bonds with similar features to SISs which are not regularly traded? If not, please give reasons.

Excluding SPV structures for single-company investments

- 3.28** Our temporary rules for SISs were not intended to capture single-company debt or equity investments where the company is funding its own commercial or industrial business, or that of a group entity, provided this does not involve using funds to lend to third parties, buy or acquire investments, or buy or fund the construction of property (subject to limited exemptions). The more common and 'vanilla' form of investment or debt based crowdfunding of specific companies therefore remains subject to the existing rules for NRRSs.
- 3.29** Following our temporary rules, we have become aware of some structures that involve an investment firm facilitating investment in a single company by using a separate SPV to hold investors' funds. The SPV as a legal entity then makes a single investment in a company funding its commercial or industrial activity, which has been specifically chosen by the investor. However, an investor's exposure to the SPV may take the legal form of a debenture or preference share structured in such a way as to give them legal rights to any return or capital gain realised from the securities acquired by the SPV on their behalf – with the SPV issuer having no other function or discretion. As such, these features mean the arrangement is caught by our temporary rules as a form of SIS.
- 3.30** We recognise that such a structure, subject to conditions to ensure the function of the SPV is purely to hold the investment in the underlying company while giving investors a 'look-through' exposure to the underlying company, is comparable to investing directly in the same underlying company. On that basis, we consider the treatment of financial promotions should be consistent.
- 3.31** While we have issued a waiver for one specific case where this structure has arisen, we consider it is reasonable to provide for a general carve out based on the substantive features of this structure as explained above, to ensure fairness for other crowdfunding platforms that may wish to use this legal form. Investments meeting the conditions we set out for what we have called a 'single-company holding vehicle' will therefore be subject to the requirements for NRRSs and not be subject to the more restrictive financial promotions rules we propose for SISs.

Q3: Do you agree with our proposal to introduce an exclusion for SPV structures for single-company investments? If not, please give reasons.

Clarifications to the TPI rules

3.32

Based on feedback to the TPI rules in COBS 4.14, we have sought to clarify some of the exemptions to the SIS definition and other technical aspects in the proposed permanent rules. These seek to ensure our rules are clear for market participants and are interpreted as we intended, as well as being proportionate to the risk of harm. Specifically, we have proposed drafting changes compared with the current rules to do the following.

- Clarify the existing exemption for issuers that raise funds to acquire or develop property to be used in the course of their own industrial or commercial purpose, or that of a group entity, provided that their ability to repay investors is also not wholly or predominantly linked to, contingent on, sensitive to or dependent on the return generated from the purchase or construction of the property. Following feedback, we consider that including within the scope of the TPI rules securities where the ability of an issuer in these circumstances to repay is 'sensitive to' such acquisition or development (see existing COBS 4.14.18R (2)) creates too broad an application and could potentially undermine our policy intention to exclude issues of securities to fund a commercial or industrial business. We therefore propose to change this so that only securities where the issuer's ability to repay is 'highly sensitive' to the relevant purchase or development are subject to the TPI rules.
- Change the single-property holding vehicle exemption to also enable issuances that fund single property purchases or purchases of multiple properties within a single development that are let for affordable or social housing in the UK (and therefore may not represent a 'commercial rent'). This will enable such securities to be marketed more openly to retail investors and not unduly restrict financing relating to the Housing Association sector. This is consistent with our policy intention that the relevant property should be capable of generating income (rather than being speculative).
- Clarify further that an 'income generating property' for the purpose of the single-property holding vehicle exemption must already be in existence, and that the exemption therefore does not apply to property development. This was the intended effect of the existing rules, as we noted in paragraph 1.42 of our original TPI statement. The TPI rules already require that the relevant property must be occupied or available for occupation by relevant persons and have been valued, but we propose to clarify that the property must also be used, or be available for use (rather than be intended to be used) for relevant purposes. We are also clarifying that the vehicle holding the property for the purpose of this exemption must be the sole owner of a single income generating property. This means that the product is less complex and easier for the investor to understand.
- Set out expressly in the Handbook that where a security meets the definition for a SIS and is subject to the rules we are proposing, it is excluded from the definition of an NRRS and so is not subject to requirements in COBS 4.7.7R to 4.7.13R which we did not intend to apply and should be mutually exclusive. SISs will however remain subject to the same requirements as NRRSs outside of COBS 4.7, eg COBS 10 Appropriateness.
- Clarify that securities with a denomination or minimum investment of exactly £100,000 are not caught by the restrictions. Securities of this denomination are generally considered to be above the level at which a retail investor would invest, and securities with a denomination above this amount are already excluded from the TPI rules.
- Clarify that the reference to buying or acquiring 'investments', other than financial products falling within the Handbook definition of 'specified investments', in the definition of a SIS does not include cases where the proceeds of the debenture or

preference share are used to buy assets which are used by the issuer or a member of its group for a general commercial or industrial purpose which it carries on. We again exclude from this exemption cases where an issuers' ability to pay interest or repay capital to investors is dependent or contingent on the return generated from the investment. This is intended to exclude fundraising by companies that issue securities to fund ordinary business activity that is not highly speculative, which will remain subject to the rules for marketing NRRSs.

- Clarify that a general industrial or commercial purpose does not include buying or developing a property, or buying an investment, which is held for the purposes of renting, hiring or leasing it to a third party. We would expect most SISs which fund these activities to be excluded from the existing exemption in COBS 4.14.18R (1), which applies where the issuer or a member of its group uses the relevant property or investment for a general commercial or industrial purpose which it carries on, because of the requirement that issuer's ability to pay interest or repay capital to investors must not be wholly or predominantly linked to, contingent on, highly sensitive to or dependent on a return generated by the relevant property or investment. However, we are setting this out expressly in the permanent rules to remove any doubt.

3.33 These changes are all designed to make the scope of the overall measures clear. To a limited extent, they remove some issuers or issuances from the current requirements of the temporary rules where this is in line with the original intention of the TPI.

Q4: Do you agree with our proposed clarifications to the TPI rules? If not, please give reasons.

Clarifying how promotions are restricted for SISs and NMPIs

3.34 Responses to our temporary rules identified one existing area linked to our rules for NMPIs that external stakeholders felt lacked clarity. This concerned the nature of the marketing restriction and how promotions can be 'made to' recipients. This links to language used in both COBS 4.12.4R, COBS 4.14.3R and associated guidance.

3.35 Prospective retail investors need to be identified as falling into an exempt category (such as the certified high net worth or self-certified sophisticated investor categories) before being able to receive or access financial promotions for the relevant products. We have been clear about this in statements supporting both the introduction of temporary rules for SISs last year (eg paragraphs 2.13 and 2.14 of our [original TPI statement](#)) and when making the original NMPI rules (eg page 21 of [PS13/3](#)). This is also supported by guidance in COBS 4.12.5G (2)(a) and COBS 4.14.4G (1) concerning 'preliminary suitability assessments', which states the timing of such a check is intended to be before receipt of any promotions. In practical terms, this means firms and products subject to our rules should not allow open availability on a website of specific financial promotions, even if subject to an initial warning or 'tick box' informing investors an investment is only available to clients who subsequently meet a relevant exemption.

3.36 However, we recognise that the language we use in the relevant rules could be clearer on this intended effect. So we are proposing as part of final rules for marketing restrictions on SISs that we clarify both the language in these rules and the rules for NMPIs to make clear the order in which the 'vetting' of investors and access to a financial promotion should occur. The proposed drafting amendments are intended to ensure the following steps are taken under the relevant exemptions for SISs or NMPIs:

- investors are first assessed to determine whether they fall within an exemption provided for in the rules (for example, as certified high net worth or self-certified sophisticated investors)
- investors are then subject to a preliminary suitability assessment where required
- finally, a financial promotion can then be made to or be directed at eligible recipients who have been assessed as such under the first two bullet points

3.37 The proposal described above is not intended to change the substance of the existing rules and instead is intended to clarify the drafting in line with our previous statements and guidance on this issue.

Q5: **Do you agree with our proposal to clarify how promotions are restricted for SISs and NMPIs? If not, please give reasons.**

Annex 1

Questions in this paper

- Q1:** Do you agree with our proposal to make the TPI requirements permanent? If not, please give reasons.
- Q2:** Do you agree with our proposal to expand the scope of the TPI rules to listed bonds with similar features to SISs which are not regularly traded? If not, please give reasons.
- Q3:** Do you agree with our proposal to introduce an exclusion for SPV structures for single-company investments? If not, please give reasons.
- Q4:** Do you agree with our proposed clarifications to the TPI rules? If not, please give reasons.
- Q5:** Do you agree with our proposal to clarify how promotions are restricted for SISs and NMPIs? If not, please give reasons.

Annex 2

Cost benefit analysis

Introduction

1. FSMA, as amended by the Financial Services Act 2012, requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as 'an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made' and 'an estimate of those costs and of those benefits'. Section 138I also provides that if, in our opinion, the costs or benefits cannot reasonably be estimated or it is not reasonably practicable to produce an estimate, the cost benefit analysis need not estimate them; in that case, the CBA must include a statement of our opinion and an explanation of it. Section 138L provides that if the increase in costs is of minimal significance, we are not obliged to produce a CBA.
2. Our CBA presents estimates of the significant impacts of our proposal. We provide monetary values for the impacts where we believe it is reasonably practicable to do so. For others, we provide analysis of outcomes in other dimensions. Our proposals are based on carefully weighing up the impacts we foresee and reaching a judgement about the appropriate level of consumer protection (see Chapter 2 of the CP above for additional detail).

Problem and rationale for intervention

3. A speculative illiquid security (SIS) is a financial product that without our temporary product intervention (TPI) rules would be available for mass-marketing to all retail consumers. SISs are debentures or preference shares which meet certain conditions and are typically debentures issued through a special purpose vehicle that offer a high fixed rate of return for a fixed period with little or no opportunity to sell or transfer the investment before the end of the period. Other features of SISs are described in Chapter 2 of the CP. FCA analysis of online promotions for SISs shows that 81% of bonds have an advertised coupon rate equal to or above 6%, and 48% offer a return equal to or above 8%. The funds raised are used for speculative purposes such as financing development projects or lending to other companies.
4. SISs are high risk. In January 2019, the biggest issuer of SISs – London Capital & Finance (LCF) entered administration and around 11,600 customers lost their investments. Other large firms such as Basset & Gold Plc and Blackmore Bond Plc have entered administration (both in April 2020). Across the three cases, consumers lost approximately £300 million, which represents approximately 21% of the estimated outstanding amount in the SIS market in 2019. These events highlight the high risk of default for SISs and the potential for significant consumer harm.

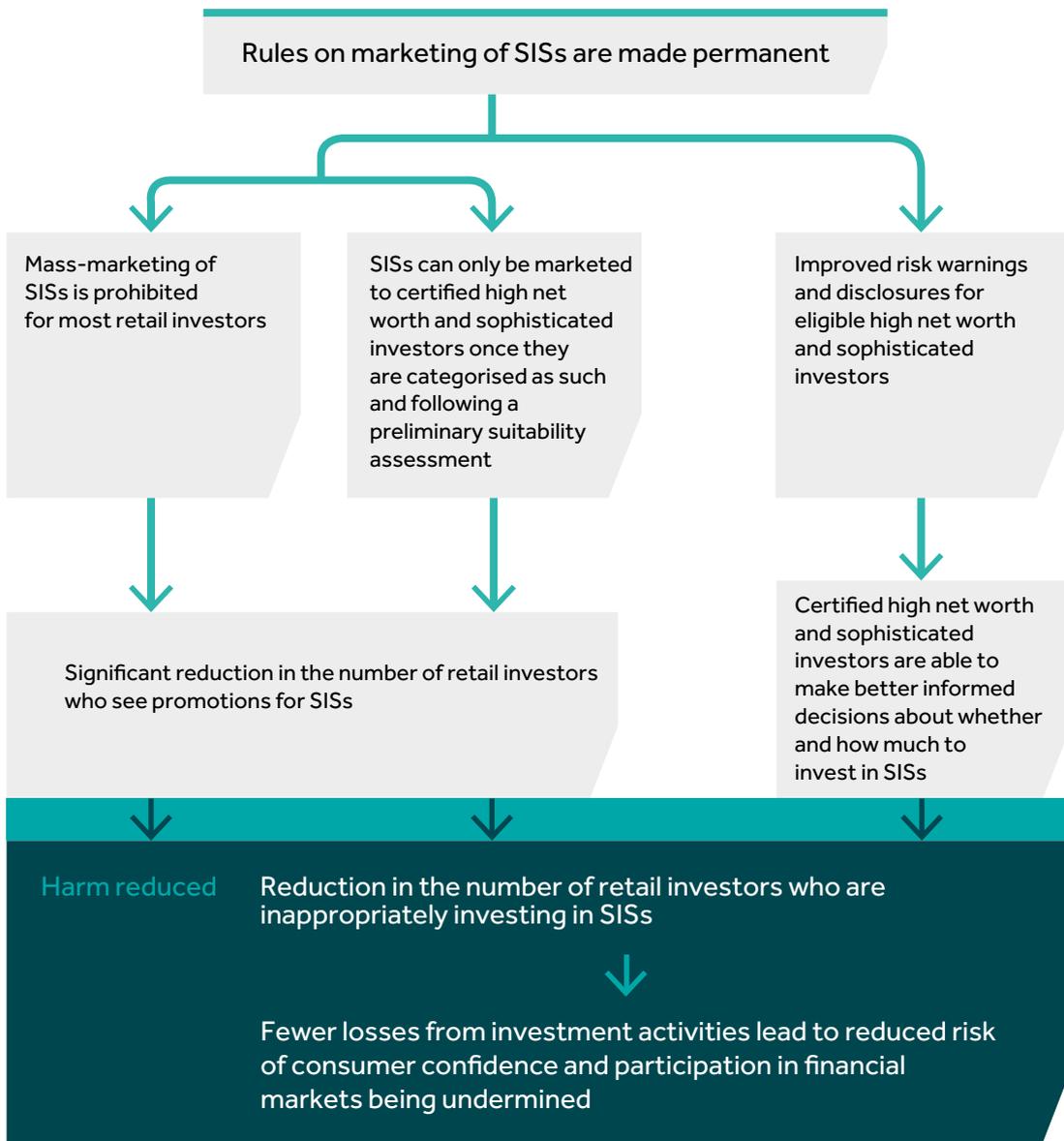
5. Yet SISs are held by a large number of retail consumers and there would be significant losses for individuals if an issuer failed and little or no money was repaid. FCA data suggests that prior to the TPI in January 2020, there may have been upwards of 63,500 retail bondholders that held similar investment products as those issued by LCF, with an average investment amount being £22,100 (Updated FCA analysis of SISs prior to the introduction of the TPI). We note that the actual number of bondholders may be significantly higher, as our estimate does not include those bondholders who have purchased listed SISs that are not regularly traded or SISs sold through crowdfunding platforms due to data limitations.
6. We have identified the mass-marketing to retail investors, together with insufficient risk warnings, to be the drivers of harm in the SIS market. These practices take advantage of 'saliency' bias – i.e. the tendency for retail consumers to focus on the high rate of return presented in promotions and underestimate the riskiness of SISs.
7. Research by the FCA and Warwick Business School found that when controlling for advertised return on promotions, our sample of participants, who on average had low investment experience, generally preferred a safer investment (Cash ISA) to more risky ones. In the same experiment, however, SISs were preferred to stocks and shares ISAs, suggestive that consumers may wrongly perceive SISs as the less risky option.
8. A second experiment showed that when the new risk warning proposed by our intervention (see section below) was applied to the promotion, participants' comprehension of the investment risk associated with SISs improved. This means the new risk warnings we are proposing may reduce harm by improving consumer perception of product riskiness, resulting in more appropriate investment decisions. We note that under the new rules, risk warnings will be shown on promotions that can only be advertised to people who are certified high net worth or sophisticated investors and have passed a preliminary suitability assessment. This population is likely to have different characteristics and risk preferences than the sample in the study, so the results may not have exact carryover. Nonetheless, we believe that there is no reason that an improved comprehension of risks would not be true for high net worth and sophisticated investors. Even if this group has different risk preferences, or better understanding of risks than the general population, clearer warnings may enable more appropriate investment choices by them.
9. Overall, evidence suggests that SISs carry high risks that consumers may not assess well. This may lead to inappropriate investment decisions and significant consumer harm. We believe that appropriate rules on financial promotions of SISs are needed to address these issues, prevent unsuitable investments being sold to retail consumers and reduce significant and unexpected financial losses.

Summary of our proposed intervention

10. Our proposals are set out in detail in the CP. They seek to address the drivers of harm we have identified in relation to SISs, in particular by:
 - preventing the mass-marketing to retail investors of certain types of speculative investment which we have identified as not generally suitable for them

- improving the disclosure of key risks and costs to those certified high net worth and (certified or self-certified) sophisticated retail investors who can still receive promotions for these types of investment

- Our proposals will prevent mass-marketing of SISs and require a process where prospective investors are pre-vetted based on the relevant conditions, to enable promotions to target only a restricted set of eligible investors.
- Firms will also need to ensure any promotions they communicate or approve for SISs contain the standardised risk warning and disclose prominently any costs or fees.
- The causal chain set out below shows how we expect our proposals to mitigate the harm.



Baseline and key assumptions

- To establish the baseline for the CBA, we have considered the requirements relating to financial promotions for SISs as they applied prior to the TPI coming into force for

authorised firms communicating their own financial promotions or approving the financial promotion of an unauthorised person. In most cases, other than for listed SISs, this means that the rules for non-readily realisable securities (NRRSs) in COBS 4.7.7R would have applied.

15. However, we note that, as the TPI came into force on 1 January 2020, promotions for SISs, other than listed SISs, should generally already be complying with the TPI rules. As such, any one-off costs in complying with the requirements for those SISs should have already been incurred (and any benefits be accruing). The estimates for one-off costs presented here therefore overestimate the incremental cost of the proposed rules.
16. We assume that the size of the market and the level of harm would go back to their pre-TPI levels if the proposals in this consultation are not implemented. Hence, our analysis of ongoing costs and benefits uses the pre-TPI level of harm as the baseline.
17. Our estimates assume that regulated firms in scope, as well as unregulated issuers of SISs who need an authorised person to approve their financial promotions, will fully comply with our rules. Many SISs have been issued to investors directly by the issuer which is often an unregulated entity, and so our proposed rules require the authorised firm approving the financial promotion (a s21 approver) to ensure that the requirements are complied with when they approve the promotion. In these situations, we expect that costs will either be incurred by the issuer, or by the s21 approver and then passed on to the issuer.
18. We are also aware that some SISs are distributed via crowdfunding platforms. In these situations, we expect that the crowdfunding platform will incur the costs (which will then be reflected in the charges to issuers).

The current market for SISs

19. Our proposals will apply to debentures and preference shares which are already subject to the TPI. We are also proposing to apply the TPI rules to listed debentures which are not regularly traded where they meet the definition of a SIS.
20. The number of firms affected by our proposals is summarised in the below table for each product.

	Firm Type	Number of Firms/ Issuers Affected	Number of securityholders
Issuers of SISs	Existing SISs sold directly through issuer	206	63,500
	Listed, but not regularly traded, SISs	45	Unknown
Regulated firms	Crowdfunding platforms selling SISs	13	Unknown
	S21 approvers	31	N/A

21. We note that these numbers are firms who we know are issuing SISs or approving promotions of SISs. Issuing a SIS is generally not a regulated activity and s21 approvers are not required to inform the FCA that they are approving financial promotions. Therefore, we do not have a full list of firms which are carrying out these activities, so the actual number of firms affected may be higher.

22. We estimate that there is a total of at least 295 issuers and regulated firms in scope.

Existing SISs sold directly through an issuer

23. SISs are currently defined as debentures and preference shares (which are not readily realisable securities) with a denomination or minimum investment of £100,000 or less, where the issuer uses the funds raised to on-lend to third parties or speculatively buy or acquire investments, or construct or buy property. FCA review of listed instruments on EEA exchanges identified 45 issuers of relevant securities. We estimate that there are 63,500 bondholders, and the total issuance amount is £3 billion.

Listed SISs issued directly

24. We are proposing to expand the scope of the TPI rules so that listed debentures which are not regularly traded on an EEA exchange and which meet the definition of a SIS are subject to the requirements. FCA review of listed instruments on EEA exchanges identified 45 issuers of relevant securities. We do not know how many retail investors have purchased these instruments as their issuance is not generally a regulated activity and we therefore do not hold regulatory data on them.

Crowdfunding platforms

25. Some SISs are distributed by crowdfunding platforms. Of these, most use the proceeds for property acquisitions, development and other infrastructure projects.
26. We currently supervise 13 firms undertaking crowdfunding activities which offer securities which could fall within the definition of a SIS.

S21 approvers

27. Any authorised firm can approve a financial promotion for an unauthorised person, including a promotion for a SIS. Our proposals are therefore in theory relevant to every authorised firm. However, we believe that in practice only a small number of firms are currently actively involved in doing this. Based on our supervisory activities we know of 31 firms who are potentially actively approving financial promotions for unauthorised issuers. However, as there is no requirement for firms to tell us that they are doing this, there may be additional firms who are currently approving promotions, or intend to do so.

Summary of costs and benefits

28. We expect that our proposals will result in direct costs to firms and/or unregulated issuers, as described below. We have estimated one-off costs to firms of £3.3m, and ongoing costs of £2.2m per year. We also expect a significant indirect cost to issuers of SISs as it becomes costlier to obtain funding. However, the reduction in funding will come through reduced investment in SISs and since consumers will be able to invest in more appropriate products, we consider that indirect costs to firms are a transfer to consumers. We do not expect any significant increase in supervision costs to the FCA.
29. We expect benefits to be realised in the form of reduced risk of financial losses for retail investors. We believe that by preventing consumers from investing in unsuitable products, consumer welfare will be improved. Finally, there are wider benefits as a result

of improved trust in the retail investments market. It is not reasonably practicable to quantify these benefits. In order to quantify benefits, one would need to estimate the causal impact of mass marketing on the propensity of retail investors to purchase SISs. We are not aware of any existing dataset that would allow us to estimate this. However, we consider that the per retail investor savings required for the policy to break even in the first year is £87. We consider that the benefits are likely to exceed this. To put this break-even number into perspective, the recent collapse of London Capital and Finance alone resulted in consumer losses of £230 million – 42 times the year 1 cost of the policy.

	One-Off/ Ongoing	Costs*	Benefits
Issuers of SISs (at least 251 firms)	One-Off	Familiarisation and Legal Costs – £450.9k	–
		IT Costs – £740.6k	
		Change and Governance – £1.7m	
Ongoing	Financing Costs – unquantified	–	
Regulated Firms (at least 44 firms)	One-Off	Familiarisation and Legal Costs – £79k	–
		IT Costs – £76.7k	
		Change and Governance – £297.7k	
Ongoing	Carrying out a preliminary suitability assessment – £2.2m Decreased revenue – unquantified	–	
Consumers	One-Off	–	–
	Ongoing	Fewer investment options available to retail consumers Increased time needed by high net worth/sophisticated investors to make purchases	Reduced risk of financial loss Purchasing more suitable investments Improved trust in the retail investments market
Total cost in year 1		£5.5m	

*Figures rounded to the nearest hundred.

Costs

Issuer and Firm Costs

- 30.** We group affected firms into two categories – SIS issuers and regulated firms. SIS issuers include 251 issuers of SISs, whether currently subject to the TPI or proposed to be brought into scope as non-regularly traded listed SISs. Regulated firms include 13 crowdfunding platforms and 31 s21 approvers. Some SIS issuers may also be regulated firms, however the issuance of a SIS is generally not a regulated activity of itself, and therefore we have included them as issuers.
- 31.** We anticipate that firms in scope will incur direct costs due to familiarisation and gap analysis, governance changes, updating their websites to prevent mass marketing to retail consumers, as well as allocating resources to conduct the preliminary suitability assessment required by our rules. We give an overview of our approach to estimating these costs in the sections below.
- 32.** We believe that it is not reasonably practicable to estimate indirect costs such as reduced ability to raise funds for SIS issuers, and decreased revenues for crowdfunding

platforms and s21 approvers. This is because we do not know by how much the volume of SIS investments will reduce as a result of the policy (see paragraph 29), or the profits generated by crowdfunding platforms and s21 approvers due to their activity in relation to SIS. However, as investors are diverted from purchasing SISs, they have more funds available to make other types of investment, which may be better suited to their needs. As such, we consider the indirect costs to firms to be a transfer to consumers.

33. We are using the FCA Standardised Cost Model (SCM) to estimate costs. Most of the affected parties are not regulated entities and as such applying the SCM relies on additional assumptions. Notably, we assume that all firms in scope will incur costs as would a medium-sized regulated firm. Medium-sized firms are defined in the SCM by their fee block – they are the 1,750 firms which pay the second-highest fees to the FCA, after the 250 firms who pay the highest fees. We consider this overestimates costs as we expect that the majority of firms affected are considerably smaller than the typical medium firm in the SCM.

Familiarisation and Legal Costs

34. We use standard assumptions to produce an estimate of familiarisation costs. We anticipate that there will be approximately 40 pages of policy documentation excluding the legal instrument. Assuming 300 words per page and a reading speed of 100 words per minute, it would take around 2 hours to read the document. It is further assumed that 5 staff at each firm will read the text. Finally, the hourly compliance staff salary is assumed to be £63, based on the Willis Towers Watson 2016 Financial Services Report, adjusted for subsequent annual wage inflation and including 30% overheads. We expect that all firms in scope will incur familiarisation costs. Hence, for the 251 issuers in scope the total familiarisation costs are estimated at £158,000. The 44 regulated firms are also expected to incur a familiarisation cost of £27,700.
35. With regard to legal costs, we assume 20 pages of legal text. We anticipate that two legal staff will read the legal instrument, taking 12 hours each. Assuming an hourly salary of £69 plus overheads brings total legal costs to £292,800 for the 251 issuers. Regulated firms are expected to incur £51,300 in legal costs.
36. **The total familiarisation and legal cost is estimated at £450,900 for SIS issuers and £79,000 for regulated firms.**

IT Change

37. We would expect firms and issuers to incur costs in updating their IT systems to implement the changes. We do not expect firms to make large scale IT changes to comply with the rules. However, we do expect firms and issuers to change their websites to comply with the requirements to stop the mass marketing to retail consumers and include the required risk warnings and disclosures. Considering the feedback we have received to our TPI, we anticipate higher IT costs for crowdfunding platforms as their business is done primarily online and IT changes are bound to be more complex for this subset of firms, which are offering different types of security subject to different requirements.
38. One-off IT costs are estimated using research on the structure of IT projects. We assume that SIS issuers will need 8 person-days of staff time from staff in 6 different roles (Business analysis team, Design team, Programming team, Project management team, Test team, Senior Management) to update their IT systems to implement the changes, across a project lasting 2 days. Using salary information from Willis Towers

Watson 2016 UK Financial Services Report, we calculate that these changes will lead issuers to incur costs of £740,600.

39. For the 13 crowdfunding platforms, we assume that the project will require 16 person-days. The anticipated cost to those firms is £76,700. We do not expect s21 approvers to need to update their websites to reflect our proposals, their role is to check that the issuer's website complies with the relevant requirements.
40. **In total, we expect one-off IT costs to be £740,600 for SIS issuers and £76,700 for regulated firms.**

Governance and Change

41. We would also expect firms to develop better procedures to comply with the rules, in particular we expect firms to update the prescribed risk warnings and disclosures.
42. The SCM captures the estimated cost of such changes through 'change projects', which principally estimates costs on the basis of time incurred by a project team and management, including senior staff time.
43. We expect that medium-sized firms would on average spend 14 days to deliver the changes required to comply with the proposed rules. The time is spread across project teams and executive and board oversight.
44. We use salary information from Willis Towers Watson, to estimate the salaries and apply a 30% overhead.
45. **Governance and Change costs are expected to be £1,698,100 for SIS issuers and £297,700 for regulated firms.**

Sales Processes

46. Finally, firms will have to identify investors that meet the relevant conditions for certified high net worth or sophisticated investor status and carry out a preliminary suitability assessment for some of their potential customers, before they can direct a financial promotion at them.
47. To model this cost, we assume that the sales process will increase by 40 minutes for every transaction. We assume that the number of transactions in the market in one year that would be present in the market without making the rules permanent, is equal to the total number of bondholders in the market pre-TPI – 63,500. We assume that the additional time will be split across all functions and we apply an average annual salary of £61,220 based on the Willis Towers Watson 2016 UK Financial Services Report.
48. **The total annual Sales Processes cost to regulated firms is expected to be approximately £2.19m.**
49. Note that the assumption about the number of transactions is based on pre-TPI numbers. We expect our temporary rules to have reduced this number significantly, hence, the cost of longer sales processes is likely to be overestimated. Furthermore, the average number of transactions per customer is likely to be greater than one, meaning that firms will have to do fewer suitability assessments than the number of transactions in a year.

Direct costs to firms marketing NMPIs

50. We are also making some changes that are relevant to firms marketing non-mainstream pooled investments (NMPIs). These changes are explained in paragraphs 3.34-3.37 of the CP. As we explain there, these changes are a clarification to existing rules and do not require any significant operational change as firms should already be doing what the clarifications require. Hence, these changes will only impose familiarisations costs to the firms marketing NMPIs in scope. We consider this will be of minimal significance as the text relevant to NMPIs is approximately two pages.
51. We have no evidence that NMPI firms are non-compliant with our rules prior to the clarification. However, if firms do need to change their processes as a result of the clarifications, we expect the changes to be resolved through a change project taking up no more than 3 person days and subject to executive and board oversight. We expect the cost per firm in such cases to be £2,600. Given that we do not know how many firms, if any, are non-compliant, it is not reasonably practicable to produce an assessment of the total costs of the clarification for all firms.

Indirect costs to issuers and firms

52. As a result of our proposals we expect there to be a reduction in the number of retail investors who buy or make further investments in SISs, which would impact the amount of funds that issuers of SISs raise, and the profitability of platforms and other intermediaries which distribute them. However, the aim of our intervention is to reduce the amount of retail investors' funds inappropriately invested in SISs, hence we consider any reduction in the funds raised by SISs issuers or profits of regulated firms a beneficial transfer to consumers.

Indirect costs to businesses funded by the onward use of the issue proceeds of SISs

53. Our proposals may reduce funding to some businesses which rely on on-lending or investment from SISs. However, we do not think that there is an alternative approach that would provide appropriate protection to ordinary retail investors. We believe that overall reduced investment in SISs will mean that retail investors' savings are more likely to be invested elsewhere in the economy.

Costs to consumers

54. The proposal for marketing restrictions for SISs will cause a reduction in apparent choice and access to certain investments for ordinary retail investors. However, we consider this to be appropriate given the risks of harm posed by SISs. Our proposals do not prevent targeted promotions of SISs to a niche retail market of certified high net worth and sophisticated investors, subject to compliance with the other requirements for promoting SISs.
55. Firms will be required to identify certified high net worth and sophisticated investors for whom a SIS may be suitable before they can direct a financial promotion for a SIS at them. As a result of this change, certified high net worth and sophisticated investors may have less visibility of SISs available to them. In addition, certified high net worth and self-certified sophisticated investors will go through a preliminary suitability assessment incurring a time cost. However, we do not believe that this cost is quantifiable as it is not reasonably practicable to estimate the number of certified high

net worth and self-certified sophisticated investors who are currently in the market and will remain so post-implementation of the proposed rules.

Costs to the FCA

56. There are no expected additional resource implications relating to our activities from the proposals. Compliance will be monitored through business as usual processes within existing resources.

Benefits for consumers

57. Our proposals are aimed at preventing retail investors from buying SISs which are not suitable for them and which they do not understand. Where a SIS is a suitable investment, our proposals seek to ensure that consumers make an informed decision on whether, and if so how much, to invest. As well as the benefits to consumers from purchasing more suitable investments, there are benefits from reduced risk of financial loss and improved trust in the retail investments market. It is not reasonably practicable to estimate any of these benefits as it would require us to know exactly what investments consumers will use as substitutes, which we cannot predict.
58. Our calculations suggest that the total cost of the policy in year one is £5.5 million, and £2.2 million every year onwards. Data held by the FCA suggests that there are more than 63,500 securityholders in the market. Assuming that this volume remains the same in the absence of the intervention, the savings per consumer required for the policy to break even after one year is £87. We consider that the benefits are likely to exceed this. To put the break-even number into perspective, the recent collapse of London Capital and Finance alone resulted in consumer losses of £230 million – 42 times the year one cost of the policy for all firms.

Annex 3

Compatibility statement

Compliance with legal requirements

1. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this consultation, including an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under the Financial Services and Markets Act 2000 (FSMA).
2. When consulting on new rules, the FCA is required by section 138I(2)(d) FSMA to include an explanation of why it believes making the proposed rules is (a) compatible with its general duty, under s. 1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with its strategic objective and advances one or more of its operational objectives, and (b) its general duty under s. 1B(5)(a) FSMA to have regard to the regulatory principles in s. 3B FSMA. The FCA is also required by s. 138K(2) FSMA to state its opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.
3. This Annex also sets out the FCA's view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (s. 1B(4)). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.
4. In addition, this Annex explains how we have considered the recommendations made by the Treasury under s. 1JA FSMA about aspects of the economic policy of Her Majesty's Government to which we should have regard in connection with our general duties.
5. This Annex includes our assessment of the equality and diversity implications of these proposals.
6. Under the Legislative and Regulatory Reform Act 2006 (LRRRA) the FCA is subject to requirements to have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions like making rules). This Annex sets out how we have complied with requirements under the LRRRA.

The FCA's objectives and regulatory principles: Compatibility statement

7. The proposals set out in this consultation are primarily intended to advance the FCA's operational objective of consumer protection. They are also relevant to the FCA's integrity objective.
8. Our consumer protection objective is to secure an appropriate degree of protection for consumers. In considering what degree of protection may be appropriate we are required to have regard to the 8 matters listed in FSMA s.1C(2)(a)-(h).

The differing degrees of risk involved in different kinds of investment or other transaction

9. The proposals in this CP are designed to reduce/prevent the harm to consumers from investing in complex, higher-risk products that they do not understand and are not suitable for them. We have seen several examples illustrating that investing in these types of securities can lead to unexpected and significant losses for retail investors. We have sought to distinguish the most complex and opaque types of security from other investments which will remain subject to our NRRS rules.

The principle that consumers are provided with a level of care that is appropriate given the risk involved in the transaction and capabilities of the consumer and the differing degrees of experience and expertise that consumers may have

10. We consider that SISs are in general unlikely to be suitable investments for most retail consumers. Our proposals permit marketing to consumers who are certified high net worth or sophisticated investors, provided the requirements to classify them as such and perform a preliminary suitability assessment are complied with first.

The needs that consumers may have for the timely provision of information and advice that is accurate and fit for purpose

11. Our proposals require that promotions to certified high net worth or sophisticated investors who are eligible to receive them include disclosure of key risks and costs.

The general principle that consumers should take responsibility for their decisions

12. As noted above, we consider that SISs are in general unlikely to be suitable investments for most retail consumers. Our proposals permit marketing to consumers who are certified high net worth or sophisticated investors subject to requirements being met.

The different expectations that consumers may have in relation to different kinds of investment

13. As noted above, our proposals are designed to reduce/prevent the harm to consumers from investing in complex, higher-risk products that they do not understand and are not suitable for them. We have sought to distinguish the most complex and opaque types of security from other investments which will remain subject to our NRRS rules.

Any information which the consumer financial education body has provided to us in the exercise of consumer financial education function

14. This matter is not relevant to these proposals.

Any information received from the Financial Ombudsman Service

15. In many instances, the issue of SISs does not fall within the Financial Ombudsman Service's compulsory jurisdiction, in particular, where the only role being performed by an authorised firm is to approve a financial promotion communicated by an unauthorised issuer (the s21 approver) and where that approval is not connected to a regulated activity being carried on by the s21 approver.

16. Our integrity objective is to protect and enhance the integrity of the UK financial system, which includes the matters listed in FSMA s.1D(2)(a)-(e). Our measures support this as failures and unexpected losses for retail investors linked to persistent, widespread and poor marketing of SISs may undermine confidence in UK financial markets and impact the soundness, stability and resilience of the UK financial system.

17. We consider these proposals are compatible with the FCA's strategic objective of ensuring that the relevant markets function well because they aim to ensure consumers invest in suitable products and prevent consumers from suffering unexpected and significant losses which could undermine confidence in UK financial markets as explained above. For the purposes of the FCA's strategic objective, "relevant markets" are defined by s. 1F FSMA.

18. We have also considered the most recent recommendations from the Treasury on aspects of the economic policy of the Government, which we should have regard to when acting to advance our objectives and meet our duties (s1JA of FSMA). We think our proposals are consistent with the economic policy of the Government. Our rules are designed to secure better outcomes for consumers and encourage appropriate competition, such that investments are targeted at consumers for whom they are suitable.

19. In preparing the proposals set out in this consultation, the FCA has had regard to the regulatory principles set out in s. 3B FSMA as summarised below.

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

20. We are pursuing cases of potential firm misconduct involving the distribution of SISs or similar products using our supervisory and enforcement powers. However, these proposals address shortcomings in our rules prior to the TPI that prevent us taking effective action in some cases. The measures should also improve the overall quality of new promotions for SISs across the market. This is more effective and efficient than taking a case-by-case approach to promotions for different products as they appear.

The principle that a burden or restriction should be proportionate to the benefits

21. We consider that SISs are in general unlikely to be suitable investments for most retail consumers given the risks involved and their potentially complex and opaque nature. We therefore consider that a restriction on mass-marketing is proportionate. As noted above we have sought to distinguish the most complex and opaque types of security from other investments which will remain subject to our NRRS rules.

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

22. We consider our measures will enhance confidence in UK markets, and encourage inward investment and growth, by reducing the likelihood of future mis-selling cases linked to the marketing of SISs to retail investors. If some issuers raise less funds in future due to our rules, we consider that is likely to affect those propositions that are most risky and least sustainable. This is positive for the wider economy if consumers' savings are instead invested in a way that is more likely to fund productive companies' industrial or commercial operations that are non-speculative, with better prospects of sustainable growth. In this regard, we have sought to distinguish the most complex and opaque types of security from issuances by issuers which do so to fund their ordinary, non-speculative business activity.

The general principle that consumers should take responsibility for their decisions

23. As noted above, we consider that SISs are in general unlikely to be suitable investments for most retail consumers. Our proposals permit marketing to consumers who are certified high net worth or sophisticated investors provided the relevant requirements are complied with.

The responsibilities of senior management

24. Relevant senior management will need to ensure that firms comply with our proposed rules, having regard to their responsibilities under the senior managers and certification regime (SMCR), which has applied to most authorised firms since 9 December 2019.

The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons including mutual societies and other kinds of business organisation

25. We have sought to distinguish the most complex and opaque types of security from issuances by companies who do so to fund their own (non-speculative) businesses, which will remain subject to our NRRS rules.

The desirability of publishing information relating to persons subject to requirements imposed under FSMA, or requiring them to publish information

26. We do not think our rules will impact this.

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

27. We published our TPI in November 2019, at the time explaining the rationale for our intervention and describing the rules we were applying. We are now consulting on permanent rules.
28. In formulating these proposals, the FCA has had regard to the importance of taking action intended to minimise the extent to which it is possible for a business carried on (i) by an authorised person or a recognised investment exchange; or (ii) in contravention of the general prohibition, to be used for a purpose connected with financial crime

(as required by s. 1B(5)(b) FSMA). We have seen examples of issuances of SISs being scams, although they usually are non-compliant with our financial promotions rules and/or in breach of s21 FSMA. By preventing the mass-marketing of SISs, we will make it more difficult for those seeking to defraud consumers using SISs to either reach the general public, or alternatively to be able to disguise their activity in the absence of genuine propositions being advertised more widely.

Expected effect on mutual societies

29. The FCA does not expect the proposals in this paper to have a significantly different impact on mutual societies as they apply in the same way to all firms.

Compatibility with the duty to promote effective competition in the interests of consumers

30. In preparing the proposals as set out in this consultation, we have had regard to the FCA's duty to promote effective competition in the interests of consumers.
31. Our proposals will cause an apparent reduction in choice and access to certain investments for ordinary retail investors. However, we consider this to be appropriate given the risks of harm posed by the way SISs have been promoted. Our measures do not prevent targeted promotions of investments to a niche retail market for whom they may be suitable, subject to the required risk disclosure and details of any costs or fees deducted from monies raised.
32. By contrast, the targeting of an excessively wide retail market with promotions for these products that lack prominent and balanced disclosures of risks and costs or fees which we previously saw does not represent positive competition in the interest of consumers.
33. We are aware that there may be an increase in businesses seeking funding as a result of coronavirus (Covid-19). Our proposals will reduce a source of funding to some businesses. This is more likely for smaller businesses that have novel business models or seek to intermediate lending to individuals or businesses. However, we do not think there is an alternative approach that would provide appropriate investor protection while promoting competition in the interests of consumers. Overall, reduced investment in SISs should mean that investors' savings are more likely to be invested in alternative investments such as stocks and shares ISAs. These products may be more suitable for consumers, generating a return in exchange for a level of risk that retail consumers can bear.

Equality and diversity

34. We are required under the Equality Act 2010 in exercising our functions to 'have due regard' to the need to eliminate discrimination, harassment, victimisation and any other conduct prohibited by or under the Act, advance equality of opportunity between persons who share a relevant protected characteristic and those who do not,

and to foster good relations between people who share a protected characteristic and those who do not.

- 35.** As part of this, we ensure the equality and diversity implications of any new policy proposals are considered. The outcome of our consideration in relation to these matters in this case is explained in Chapter 2 of this CP.

Legislative and Regulatory Reform Act 2006 (LRR)

- 36.** We have had regard to the principles in the LRR for the parts of the proposals that consist of general policies, principles or guidance and consider that our proposals are:

- Transparent: as set out above
- Accountable: following us making the restrictions as temporary product intervention rules, using our powers under s137D and s138M of FSMA, we are now consulting and seeking feedback on whether to make the TPI rules permanent before they expire after 12 months
- Proportionate: as set out above
- Consistent: our approach would apply in a consistent manner to all firms considering marketing or approving promotions in relation to SISs targeting retail clients. Our measures are also consistent with the rules for NMPIs, which we consider present comparable risks
- Targeted only at cases in which action is needed: we consider there is significant need for these measures given the harm and the drivers of that harm we have identified, as explained in the CP

- 37.** We have had regard to the Regulators' Code for the parts of the proposals that consist of general policies, principles or guidance and consider that our proposals meet those principles. In particular, the proposals are based on preventing mass-marketing of those securities which we consider present most risk to consumers. As noted above, we are now consulting on the proposals following their introduction as a temporary product intervention.

Annex 4

Abbreviations used in this paper

COBS	Conduct of Business Sourcebook
CP	Consultation Paper
FPO	Financial Promotion Order
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
IBCF	Investment-Based Crowdfunding
IF ISA	Innovative Finance Individual Savings Account
HRI	High-Risk Investment
NMPI	Non-Mainstream Pooled Investment
NRRS	Non-Readily Realisable Security
SIPP	Self Invested Personal Pension
SIS	Speculative Illiquid Security
SPV	Special Purpose Vehicle
TPI	Temporary Product Intervention
UCIS	Unregulated Collective Investment Scheme



We make all responses to formal consultation 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.

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Appendix 1

Draft Handbook text

**CONDUCT OF BUSINESS (SPECULATIVE ILLIQUID SECURITIES)
INSTRUMENT 2020**

Powers exercised

- A. The Financial Conduct Authority (“the FCA”) 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 (The FCA’s general rules);
 - (2) section 137D (FCA general rules: product intervention);
 - (3) section 137R (Financial promotion rules);
 - (4) section 137T (General supplementary powers);
 - (5) section 139A (Power of the FCA to give guidance); and
 - (6) section 238(5) (Restrictions on Promotion)
- B. The rule-making provisions listed above are specified for the purposes of section 138G(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on 1 January 2021.

Amendments to the 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.

Notes

- F. In Annex B to this instrument, the “note” (indicated by “*Editor’s note:*”) is included for the convenience of readers but does not form part of the legislative text.

Citation

- G. This instrument may be cited as the Conduct of Business (Speculative Illiquid Securities) Instrument 2020.

By order of the Board
[date]

Annex A

Amendments to the Glossary of definitions

Insert the following new definitions into the appropriate alphabetical positions. The text is not underlined.

income generating property a single property or multiple properties within a single development which:

- (1) is actually used, or is available for use, for residential or commercial purposes;
- (2) is located in the *United Kingdom*;
- (3) is available for occupancy or occupied by *persons* who have no relationship with the *directors* of the *property holding vehicle* and who pay rent at a commercial rate, or a rate reflecting regulated market practice for social and affordable housing; and
- (4) has been valued by an independent valuer:
 - (a) who is a member of the Royal Institute for Chartered Surveyors; and/or
 - (b) in accordance with the RICS Valuation Standards (The Red Book).

property holding vehicle a single *body corporate* which:

- (1) is the sole legal or beneficial owner of a single *income generating property*;
- (2) issues *debentures* which have a fixed maturity date or *preference shares*;
- (3) issues *debentures* or *preference shares* in a sum which does not exceed the value of the *income generating property* owned;
- (4) issues only one tranche of *debentures* or *preference shares*;
- (5) is only engaged with the holding of *income generating property* and associated activities including the collection of rent or other income from the *income generating property* and appointing a manager to maintain the *income generating property*; and
- (6) does not enter into any loan agreement whether as the borrower or lender.

single-company holding vehicle

a *single body corporate* which:

- (1) is only able to carry on the following activities:
 - (a) issuing *debentures* or *preference shares* for the purpose of investing the proceeds in *shares* or *debentures* issued by a *single company* (without prejudice to the *single-company holding vehicle's* ability to constitute the vehicle);
 - (b) investing the total proceeds of the *debentures* or *preference shares* it issues in *shares* or *debentures* issued by a *single company* and no other *company*, and has no discretion in relation to the proceeds of the issue;
 - (c) paying returns to investors in sums equal to any income it receives from the *shares* or *debentures* it owns in the *single company*, including income from any sale of the *shares* or *debentures*, on a pro rata basis, less any reasonable fees (without prejudice to relevant legislation governing companies and taxation); and
- (2) has adequate arrangements in place to ensure that:
 - (a) the proceeds of the issue are protected and not used for any purpose outside of (1)(b) above; and
 - (b) either:
 - (i) income from the *single company* is held by the *single-company holding vehicle* on trust for investors on terms that ensure that those investors receive the full amount they are entitled to according to (1)(c) above; or
 - (ii) the investors have security over the income from the *single company* on terms that ensure that those investors receive the full amount they are entitled to according to (1)(c) above; and
- (3) ensures that neither the *single company*, nor members of its *group*, will use any of the monies received from the *single-company holding vehicle* directly or indirectly for one or more of the purposes in COBS 4.14.18R(2).

single company

a *single company* that is not part of the same *group* as the *single-company holding vehicle* investing in it and which:

- (a) uses the funds received from the *single-company holding vehicle* solely for the purpose of its own commercial operations or those

of its *subsidiaries* carrying out the same commercial operations as the *single company*; and

- (b) does not undertake any of the activities in *COBS 4.14.18R(2)*.

speculative illiquid security has the meaning in *COBS 4.14.18R*.

Amend the following definition as shown. Underlining indicates new text and striking through indicates deleted text.

*non-readily
realisable security* ...

- (e) a deferred share issued by a *credit union*; ~~or~~
 (f) *credit union subordinated debt*; or
 (g) a speculative illiquid security.

Annex B

Amendments to the Conduct of Business sourcebook (COBS)

[*Editor's note:* The United Kingdom left the European Union on 31 January 2020 with a Withdrawal Agreement. It has entered a transition period which is due to operate until 31 December 2020. This instrument takes account of the changes made to the Handbook in the instruments that were published in PS19/5 in February 2019 and the unmade instruments in CP19/33: Quarterly Consultation Paper No 26 in December 2019, as if those changes had been made.

All provisions in the Handbook marked “[deleted]” as a result of FCA 2019/99 are replaced by the content in this instrument.]

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

2 Conduct of business obligations

...

2.2 Information disclosure before providing services (other than MiFID and insurance distribution)

Application

2.2.-1

R ...

(2) ...

(a) in relation to a *derivative*, a *warrant*, a *non-readily realisable security*, a *speculative illiquid security*, a *P2P agreement*, or *stock lending activity*, but as regards the matters in *COBS 2.2.1R(1)(b)* only; and

...

(3) Where a *rule* in this section applies to a *firm* carrying on *designated investment business* in relation to a *speculative illiquid security*, the *rule* also applies to a *TP firm* (to the extent that the *rule* does not already apply to such a *TP firm* as a result of *GEN 2.2.26R*).

4 Communicating with clients, including financial promotions

...

4.7 Direct offer financial promotions

...

4.7.11 G ...

4.7.11A G COBS 4.7.7R does not apply to speculative illiquid securities. Firms and TP firms are reminded of the restrictions on financial promotions in relation to speculative illiquid securities in COBS 4.14.

...

4.12 Restrictions on the promotion of non-mainstream pooled investments

Restrictions on the promotion of non-mainstream pooled investments

4.12.3 R ...

(3) References to a firm in this section include a TP firm to the extent that this section does not already apply to those TP firms as a result of GEN 2.2.26R.

Exemptions from the restrictions on the promotion of non-mainstream pooled investments

4.12.4 R (1) The restriction in COBS 4.12.3R does not apply if the promotion falls within an exemption in the table in (5) below in accordance with (3).

(2) A ~~firm~~ firm may communicate an invitation or inducement to participate in an *unregulated collective investment scheme* without breaching the restriction on promotion in *section 238* of the Act if the promotion falls within an exemption in the table in (5) below in accordance with (3).

(3) ~~Where the middle column in the table in (5) refers to promotion to a category of person, this means that the invitation or inducement~~ A promotion falls within an exemption in the table in (5) below if:

(a) ~~is made only to recipients who the firm has taken reasonable steps to establish are persons in that category it is made to or directed at only those recipients who the firm has taken reasonable steps to establish are persons in the middle column of the table; or~~ and

(b) ~~is directed at recipients in a way that may reasonably be regarded as designed to reduce, so far as possible, the risk of participation in, acquisition or underwriting of the non-mainstream pooled investment by persons who are not in that category where the third column of the table refers to the need for a preliminary assessment of suitability, that assessment is undertaken before the promotion is made to or directed at the recipient.~~

- (4) ...
- (5) ...
- ...
- 4.12.5 G (1) ...
- (2) (a) The effect of COBS 4.12.4R(3)(b) is that where ~~A~~ a firm which wishes to rely on exemptions 2 (certified high net worth investors) or 9 (self-certified sophisticated investors), as provided ~~under by~~ COBS 4.12.4R(5), ~~should note that these exemptions require a~~ the preliminary assessment of suitability must be undertaken before promotion of the *non-mainstream pooled investment* is made to or directed at clients (in addition to other requirements).
- ...
- ...

Insert the following new section, COBS 4.14, after COBS 4.13 (UCITS). The text is not underlined.

4.14 Restrictions on the promotion of speculative illiquid securities to retail clients

Application and purpose

- 4.14.1 R (1) This section applies to:
- (a) *firms*; and
- (b) *TP firms*,
- when *approving or communicating financial promotions* in relation to *speculative illiquid securities*.
- 4.14.2 G (1) The *rules* in this section are intended to ensure that *financial promotions relating to speculative illiquid securities* are not *communicated* to ordinary retail investors.
- (2) The *rules* in this section therefore restrict *firms* and *TP firms* *approving or communicating financial promotions* in relation to *speculative illiquid securities* which are addressed to or disseminated in such a way that they are likely to be received by a *retail client*, subject to certain exemptions.

- (3) The *rules* also ensure *financial promotions* contain prominent information on key risks, costs and charges related to the *speculative illiquid security*.
- (4) The *rules* reflect the often complex and high-risk nature of *speculative illiquid securities*.
- (5) The definition of *speculative illiquid security* can be found in *COBS 4.14.18R*.

Restriction on the promotion of speculative illiquid securities to retail clients

- 4.14.3 R (1) A *firm* or a *TP firm* must not *communicate* or *approve* a *financial promotion* in relation to a *speculative illiquid security* where that *financial promotion* is addressed to or disseminated in such a way that it is likely to be received by a *retail client*.
- (2) The restriction in (1) is subject to *COBS 4.14.4R*.

Exemptions from the restriction on the promotion of speculative illiquid securities

- 4.14.4 R (1) The restriction in *COBS 4.14.3R(1)* does not apply if the *financial promotion*:
- (a) falls within an exemption in the first column in the table in (3) below; and
 - (b) is made to or directed at only those recipients whom the *firm* or *TP firm* has taken reasonable steps to establish are *persons* in the middle column of the table; and
 - (c) where the third column of the table refers to the need for a preliminary assessment of suitability, that assessment is undertaken before the *financial promotion* is made to or directed at the recipient.
- (2) A *firm* or a *TP firm* may rely on more than one exemption in relation to the same *financial promotion*.
- (3)

Title of exemption	Promotion to:	Promotion of speculative illiquid security which is:
1. Certified high net worth investor	An individual who meets the requirements set out in <i>COBS 4.14.15R</i> or a <i>person</i> (or <i>persons</i>) legally empowered to make	Any <i>speculative illiquid security</i> the <i>firm</i> or <i>TP firm</i> considers is likely to be suitable for that

	investment decisions on behalf of such an individual.	individual, based on a preliminary assessment of the <i>client's</i> profile and objectives. [See <i>COBS</i> 4.14.5G]
2. Certified sophisticated investor	An individual who meets the requirements set out in <i>COBS</i> 4.14.16R, 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</i> or the <i>TP firm's client</i> .	Any <i>speculative illiquid security</i> .
3. Self-certified sophisticated investor	An individual who meets the requirements set out in <i>COBS</i> 4.14.17R 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</i> or <i>TP firm's client</i> .	Any <i>speculative illiquid security</i> the <i>firm</i> or <i>TP firm</i> considers is likely to be suitable for that individual, based on a preliminary assessment of the <i>client's</i> profile and objectives. [See <i>COBS</i> 4.14.5G].
4. <i>Excluded communications</i>	Any <i>person</i> .	Any <i>speculative illiquid security</i> , provided the <i>financial promotion</i> is an <i>excluded communication</i> .

Preliminary assessment of suitability

- 4.14.5 G (1) The effect of *COBS* 4.14.4R(1)(c) is that where a *firm* or *TP firm* wishes to rely on exemptions 1 (certified high net worth investors) or 3 (self-certified sophisticated investors), the preliminary assessment of suitability must be undertaken before the *financial promotion* of the *speculative illiquid security* is made to or directed at *clients* (in addition to other requirements).
- (2) There is no duty to communicate the preliminary assessment of suitability to the *client*. If the *firm* or the *TP firm* does so, it must not do so in a way that amounts to making a *personal recommendation* unless it complies with the *rules* in *COBS* 9 or 9A (as applicable) on suitability.

- (3) The requirement for a preliminary assessment of suitability does not extend to a full suitability assessment, unless advice is being offered in relation to the *speculative illiquid security* being promoted, in which case the requirements in COBS 9 or 9A apply (as applicable). However, it requires that the *firm* or *TP firm* takes reasonable steps to acquaint itself with the *client's* profile and objectives to ascertain whether the *speculative illiquid security* under contemplation is likely to be suitable for that *client*. The *firm* or *TP firm* should not promote the *speculative illiquid security* to the *client* if it does not consider it likely to be suitable for that *client* following such preliminary assessment.

Requirements governing the form and content of financial promotions for speculative illiquid securities

- 4.14.6 R Subject to COBS 4.14.3R and COBS 4.14.4R, a *firm* or *TP firm* must not *communicate* or *approve* a *financial promotion* which relates to a *speculative illiquid security* unless it contains:
- (1) a risk warning that complies with COBS 4.14.7R;
 - (2) if applicable, the date on which the *financial promotion* was *approved*; and
 - (3) statements that comply with COBS 4.14.10R disclosing all costs, charges and commission.
- 4.14.7 R (1) For the purposes of COBS 4.14.6R(1), and subject to COBS 4.14.7R(2) and COBS 4.14.7R(3), the *financial promotion* must contain the following risk warning:

**You could lose all of your money invested in this product.
This is a high-risk investment and is much riskier than a savings
account**

- (2) Where the *financial promotion* contains a reference to an *innovative finance ISA*, the risk warning is as follows:

**You could lose all of your money invested in this product
This is a high-risk investment and is much riskier than a savings
account
ISA eligibility does not guarantee returns or protect you from
losses**

- (3) Where the number of characters contained in the risk warnings in this *rule* exceeds the character limit permitted by a third-party marketing provider, the following risk warning must be used:

You could lose all of your money invested in this product

-
- (4) Where the *financial promotion* does not appear on a website or mobile application, the risk warning must be provided in a *durable medium*.
- 4.14.8 R The relevant risk warning in COBS 4.14.7R must be:
- (1) prominent;
 - (2) contained within its own border and with bold and underlined text as indicated;
 - (3) if provided on a website or via a mobile application, statically fixed and visible at the top of the screen even when the *retail client* scrolls up or down the webpage; and
 - (4) if provided on a website, included on each linked webpage on the website.
- 4.14.9 G The relevant risk warning, including the font size, should be:
- (1) proportionate to the *financial promotion*, taking into account the content, size and orientation of the *financial promotion* as a whole; and
 - (2) published so that it is clearly legible against a neutral background.
- 4.14.10 R For the purposes of COBS 4.14.6R(3) the *financial promotion* must contain:
- (1) a statement which expresses as a percentage the total amount of the capital raised by the issue of the *speculative illiquid security* which will be paid out in costs, fees, charges and commissions and other expenses to any third party;
 - (2) a statement which expresses as a cash sum the percentage referred to in (1) above; and
 - (3) in addition to the statements in (1) and (2) above, a statement which provides a breakdown of the actual or potential expenditure to be paid out of an investor's capital and details of the third party (or parties) who will receive it.
- 4.14.11 G
- (1) There is an illustration of how a *firm* or *TP firm* should comply with COBS 4.14.10R(2) in (2) below.
 - (2) Where a *firm* or *TP firm* pays 30% of the total amount of capital raised by the issue of *speculative illiquid securities* towards costs, fees, charges and commissions and other expenses to any third party, the statement should say: "For every £100 you invest, £30 will be paid to third parties to meet costs, fees, charges and commissions."

- 4.14.12 R The statements providing the percentage figure in *COBS* 4.14.10R(1) and the cash sum in *COBS* 4.14.10R(2) must be:
- (1) prominent;
 - (2) contained together within their own border and with bold text;
 - (3) immediately follow the most prominent reference to the expected return on the *speculative illiquid security*; and
 - (4) published so that they are clearly legible against a neutral background.
- 4.14.13 G The statement providing the breakdown of expenditure in *COBS* 4.14.10R(3) should be included in the *financial promotion* in a clear and prominent way.
- 4.14.14 G The purpose of the statements required by *COBS* 4.14.10R is to enable an investor to consider the proportion of capital raised by an issue of *speculative illiquid securities* that will not be invested. This information should help the investor to assess the risk that the *issuer* will be unable to pay any advertised interest payments, other income or otherwise to repay the investor's capital at maturity.

Definitions of certified high net worth and sophisticated investors

- 4.14.15 R A certified high net worth investor is an individual who has signed, within the period of twelve *months* ending on the day on which the communication is made, a statement in the following terms:

“HIGH NET WORTH INVESTOR STATEMENT

I make this statement so that I can receive promotional communications which are exempt from the restriction on promotion of speculative illiquid securities. The exemption relates to high net worth investors and I declare that I qualify as such because at least one of the following applies to me:

I had, throughout the financial year immediately preceding the date below, an annual **income** to the value of **£100,000 or more**. Annual income for these purposes does not include money withdrawn from my pension savings (except where the withdrawals are used directly for income in retirement).

I held throughout the financial year immediately preceding the date below, **net assets** to the value of **£250,000 or more**. Net assets for these purposes do **not** include:

- (a) the property which is my primary residence or any money raised through a loan secured on that property; or
- (b) any rights of mine under a qualifying contract of insurance; 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; or
- (d) any withdrawals from my pension savings (except where the withdrawals are used directly for income in retirement).

I accept that the investments to which the promotions will relate may expose me to a significant risk of losing all of the money or other property invested. I am aware that it is open to me to seek advice from an authorised person who specialises in advising on speculative illiquid securities.

Signature:

Date:

4.14.16 R A certified sophisticated investor is an individual who:

(1) has a written certificate signed within the last 36 *months* by a *firm* or *TP firm* confirming they have been assessed by that *firm* or *TP firm* as sufficiently knowledgeable to understand the risks associated with engaging in investment activity in *speculative illiquid securities*; and

(2) has signed, within the period of twelve *months* ending with the day on which the communication is made, a statement in the following terms:

“SOPHISTICATED INVESTOR STATEMENT

I make this statement so that I can receive promotional communications which are exempt from the restriction on promotion of speculative illiquid securities. The exemption relates to certified sophisticated investors and I declare that I qualify as such.

I accept that the investments to which the promotions will relate may expose me to a significant risk of losing all of the money or other property invested. I am aware that it is open to me to seek advice from an authorised person who specialises in advising on speculative illiquid securities.

Signature:

Date: ”

- 4.14.17 R A self-certified sophisticated investor is an individual who has signed, within the period of twelve *months* ending with the day on which the communication is made, a statement in the following terms:

“I declare that I am a self-certified sophisticated investor for the purposes of the restriction on promotion of speculative illiquid securities. I understand that this means:

- (i) I can receive promotional communications made by a person who is authorised by the Financial Conduct Authority which relate to investment activity in speculative illiquid securities;
- (ii) the investments to which the promotions will relate may expose me to a significant risk of losing all of the property invested.

I am a self-certified sophisticated investor because at least one of the following applies:

- (a) I am a member of a network or syndicate of business angels and have been so for at least the last six months prior to the date below;
- (b) I have made more than one investment in an unlisted company in the two years prior to the date below;
- (c) I am working, or have worked in the two years prior to the date below, in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises;
- (d) I am currently, or have been in the two years prior to the date below, a director of a company with an annual turnover of at least £1 million.

I accept that the investments to which the promotions will relate may expose me to a significant risk of losing all of the money or other property invested. I am aware that it is open to me to seek advice from someone who specialises in advising on speculative illiquid securities.

Signature:

Date: ”

Definition of speculative illiquid security

- 4.14.18 R For the purposes of this section, and subject to *COBS* 4.14.19R and *COBS* 4.14.20R, a *speculative illiquid security* is a *debenture* or *preference share* which:

- (1) has a denomination or minimum investment of less than £100,000; and
- (2) has been issued, or is to be issued, in circumstances where the *issuer* or a member of the *issuer's group* uses, will use or purports to use some or all of the proceeds of the issue directly or indirectly for one or more of the following:
 - (a) the provision of loans or finance to any *person* other than a member of the *issuer's group*;
 - (b) *buying* or acquiring *specified investments* (whether they are to be held directly or indirectly);
 - (c) *buying* or acquiring *investments* other than *specified investments* (whether they are to be held directly or indirectly);
 - (d) *buying* real property or an interest in real property (whether it is to be held directly or indirectly);
 - (e) paying for or funding the construction of real property.

4.14.19 R For the purposes of COBS 4.14.18R, and notwithstanding the exemption for *readily realisable securities* in COBS 4.14.20R(3)(c), a *debenture* is also a *speculative illiquid security* if:

- (1) it meets the conditions set out in COBS 4.14.18R; and
- (2) it:
 - (a) is admitted to official listing on an exchange in the *United Kingdom* or an *EEA State*; and
 - (b) is not regularly traded on or under the rules of such an exchange; or
- (3) it:
 - (a) is a newly issued *debenture* which can be reasonably expected to be admitted to official listing on an exchange in the *United Kingdom* or an *EEA State*; and
 - (b) can be reasonably expected to be regularly traded on or under the rules of such an exchange when it begins to be traded.

4.14.20 R A *debenture* or *preference share* is not a *speculative illiquid security* where one or more of the exemptions in (1), (3) or (4) below applies.

- (1) This exemption applies where:

- (a) the *issuer* or a member of the *issuer's group* uses the proceeds of the issue for the purpose of the activities in COBS 4.14.18R(2)(c) (*buying* or acquiring *investments* other than *specified investments*) (d) (*buying* real property or an interest in real property) or (e) (paying for or funding the construction of real property); and
 - (b) the relevant property or *investment* is or will be used by the *issuer* or a member of the *issuer's group* for a general commercial or industrial purpose which it carries on.
- (2) The exemption in (1) will not apply if the ability of the *issuer* to pay in relation to the *debenture* or *preference share*:
- (a) any *coupon* or other income; and/or
 - (b) capital at maturity

is wholly or predominantly linked to, contingent on, highly sensitive to or dependent on a return generated as a result of the matters referred to in COBS 4.14.18R(2)(c) (d), or (e).

- (3) This exemption applies where the *debenture* or *preference share* is:
- (a) issued, or to be issued, by a *credit institution*;
 - (b) a *non-mainstream pooled investment*;
 - (c) a *readily realisable security* except for a *debenture* within COBS 4.14.19R; or
 - (d) a *P2P agreement*.
- (4) This exemption applies where:
- (a) the *issuer* is:
 - (i) a *property holding vehicle*; or
 - (ii) a *single-company holding vehicle*;
 - (b) any *financial promotions* made relating to the investment comply with COBS 4.7.7R to COBS 4.7.12G as appropriate; and
 - (c) any *financial promotion* made relating to a *single-company holding vehicle* clearly and prominently states which *single company* the investment relates to.

4.14.21 R (1) For the purposes of COBS 4.14.20R(1)(b), a general commercial or industrial purpose includes the following:

- (a) a commercial activity, involving the purchase, sale and/or exchange of goods or commodities and/or the supply of services; or
 - (b) an industrial activity involving the production of goods; or
 - (c) a combination of (a) and (b).
- (2) For the purposes of *COBS* 4.14.20R(1)(b), a general commercial or industrial purpose does not include:
- (a) investment to generate a pooled return;
 - (b) property development or construction services;
 - (c) hiring, leasing or rental services.

Guidance on general commercial or industrial purpose

- 4.14.22 G (1) *COBS* 4.14.18R provides that a *debenture* or *preference share* will fall within the definition of a *speculative illiquid security* where the proceeds of the issue are to be used by the *issuer* or a member of the *issuer's group* to fund various activities including *buying* or acquiring *investments* (other than *specified investments*) or the *buying* or construction of real property.
- (2) However, *COBS* 4.14.20R(1) provides an exemption in cases where the *investments* (other than *specified investments*) that are bought or acquired, or the property which is bought or constructed is or will be used by the *issuer* or a member of the *issuer's group* for a general commercial or industrial purpose which it carries on.
- (3) General commercial or industrial purpose is defined in *COBS* 4.14.21R.
- (4) The effect of the exemption in *COBS* 4.14.20R(1) is that a *debenture* or *preference share* will not be a *speculative illiquid security* where the proceeds of the issue are used by the *issuer* or a member of the *issuer's group* to buy or acquire *investments* (other than *specified investments*), or to buy or construct real property, and the relevant *investments* or property are or will be used by the *issuer* or *group* member for the purposes of its own commercial or industrial activities. This is illustrated in the examples below.
- (5) In relation to *COBS* 4.14.18R(2)(c) (*buying* or acquiring *investments* other than *specified investments*):
- (a) where a *company* issues a *debenture* or *preference share* and uses the proceeds to purchase IT equipment for use in its business, to the extent that the IT equipment might be considered an *investment*, the *debenture* or *preference*

- share* will benefit from the exemption because the IT equipment is used by the *company* for its own commercial activities (in this case, for use by its staff to provide services to customers);
- (b) where a *company* issues a *debenture* or *preference share* and uses the proceeds to buy or acquire art or fine wine as an *investment*, it will not benefit from the exemption because the art or fine wine will not be used by the *company* itself for its own commercial activities; if the art or fine wine is used to generate a pooled return, then the exemption would not apply as a result of COBS 4.14.21R(2)(a);
 - (c) where a *company* issues a *debenture* or *preference share* and uses the proceeds to purchase IT equipment for the purpose of hiring or leasing those out to another *company*, it will not benefit from the exemption because it is not using the IT equipment for the purposes of its own activities and hiring and leasing services are excluded from the definition of general commercial or industrial purpose as a result of COBS 4.14.21R(2)(c).
- (6) In relation to COBS 4.14.18R(2)(d) or (e) (*buying* or constructing real property):
- (a) where a retailer issues a *debenture* or *preference share* and uses the proceeds to build a shop, the *debenture* or *preference share* will benefit from the exemption because the property is used by the retailer for its own commercial activities (in this case, the sale of goods);
 - (b) where a property developer issues a *debenture* or *preference share* and uses the proceeds to fund the costs of a property development or construction of property, which is intended to be sold or rented out for commercial purposes or as residential dwellings, it will not benefit from the exemption because the development will not be used by the developer itself, and property development and construction services are excluded from the definition of general commercial or industrial purpose.
 - (c) where a *company* issues a *debenture* or *preference share* to fund the costs of constructing a power station which the *company* intends to operate itself with a view to selling the electricity it produces, the *debenture* or *preference share* will benefit from the exemption (unless COBS 4.14.20R(2) applies). That is because it will use the property for its own commercial or industrial activities (generating electricity).

However, *firms* and *TP firms* should also consider *COBS* 4.14.20R(2) and the guidance in (7) below.

- (7) *COBS* 4.14.20R(2) provides that the general commercial or industrial purposes exemption does not apply where the ability of the issuer to pay the *coupon* or other income or to repay capital on maturity in relation to the *debenture* or *preference share* is wholly or predominantly linked to, contingent on, highly sensitive to or dependent on the return generated as a result of the matters referred to in *COBS* 4.14.18R(2)(c), (d), or (e) (*buying* or *acquiring investments* (other than *specified investments*) or *buying* or *construction of real property*).
- (8) The effect of the above is that where a *company* issues a *debenture* or *preference share* for the purpose of funding the construction of a particular project and the *company's* ability to pay interest on the *debenture* or *preference share* or repay capital depends on the success of that project, the exemption in *COBS* 4.14.20R(1) will not apply. In those circumstances, the *debenture* or *preference share* will be a *speculative illiquid security* unless one of the other exemptions in *COBS* 4.14.20R applies.

Amend the following as shown.

9 Suitability (including basic advice) (other than MiFID and insurance-based investment products)

...

9.3 Guidance on assessing suitability

...

Investments subject to restrictions on retail distribution

9.3.5 G (1) ...

(f) *credit union subordinated debt* is subject to a restriction on *direct offer financial promotions* (see *CREDS* 3A.5);

(g) *speculative illiquid securities* are subject to a restriction on *financial promotions* (see *COBS* 4.14).

...

9A Suitability (MiFID and insurance-based investment products provisions)

...

9A.2 Assessing suitability: the obligations

...

Investments subject to restrictions on retail distribution: MiFID business and insurance-based investment products

9A.2.22 G (1) ...

(d) *contingent convertible instruments* and *CoCo funds* are subject to a restriction on sales and promotions (see *COBS 22.3*);

(e) *speculative illiquid securities* are subject to a restriction on *financial promotions* (see *COBS 4.14*).

...

10 Appropriateness (for non-MiFID and non-insurance-based investment products non-advised services) (non-MiFID and non-insurance-based investment products provisions)**10.1 Application**

...

10.1.2 R (1) This chapter applies to a *firm* which *arranges* or *deals* in relation to a *non-readily realisable security*, *speculative illiquid security*, *derivative* or a *warrant* with or for a *retail client*, other than in the course of *MiFID* or *equivalent third country business*, or facilitates a *retail client* becoming a lender under a *P2P* agreement and the *firm* is aware, or ought reasonably to be aware, that the application or order is in response to a *direct offer financial promotion*.

(2) Where a *rule* in this chapter applies to a *firm* which *arranges* or *deals* in relation to a *speculative illiquid security*, the *rule* also applies to a *TP firm* (to the extent that the *rule* does not already apply to such a *TP firm* as a result of *GEN 2.2.26R*).

14 Providing product information to clients

...

14.3 Information about designated investments (non-MiFID provisions)

14.3.1 R ...

(2) ...

- (c) *arranging* (bringing about) or *executing a deal* in a *warrant, non-readily realisable security, speculative illiquid security, or derivative*; or

...

- (3) Where a *rule* in this chapter applies to a *firm* which is *arranging* (bringing about) or *executing a deal* in a *speculative illiquid security*, the *rule* also applies to a *TP firm* (to the extent that the *rule* does not already apply to such a *TP firm* as a result of *GEN 2.2.26R*).

