

# Restrictions on the retail distribution of regulatory capital instruments

October 2014





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We are asking for comments on this Consultation Paper by 29 January 2015.

You can send them to us using the form on our website at:  
[www.fca.org.uk/your-fca/documents/consultation-papers/cp14-23-response-form](http://www.fca.org.uk/your-fca/documents/consultation-papers/cp14-23-response-form).

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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.

You can download this Consultation Paper from our website: [www.fca.org.uk](http://www.fca.org.uk).

## Abbreviations used in this paper

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<b>AT1</b>	Additional tier 1
<b>CCDS</b>	Core capital deferred share(s)
<b>CET1</b>	Common equity tier 1
<b>COBS</b>	Conduct of Business Sourcebook
<b>CoCo</b>	Contingent convertible security
<b>CRD IV</b>	Capital Requirements Directive IV
<b>CRR</b>	Capital Requirements Regulation
<b>EEA</b>	European Economic Area
<b>ESAs</b>	European Supervisory Authorities
<b>EU</b>	European Union
<b>FCA</b>	Financial Conduct Authority
<b>FSMA</b>	Financial Services and Markets Act 2000
<b>MiFID</b>	Markets in Financial Instruments Directive
<b>NMPI</b>	Non-mainstream pooled investment
<b>PPDS</b>	Profit participating deferred share(s)
<b>PRA</b>	Prudential Regulation Authority
<b>T2</b>	Tier 2
<b>UCIS</b>	Unregulated collective investment scheme(s)

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# 1. Overview

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## Introduction

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- 1.1** In August 2014 we announced the introduction of temporary product intervention rules restricting the retail distribution of contingent convertible securities (CoCos).<sup>1</sup> The rules entered into force on 1 October 2014. In this paper we are consulting on permanent rules to replace the temporary rules when they expire on 1 October 2015.
- 1.2** We also propose requirements to be imposed when certain regulatory share capital instruments issued by mutual societies are distributed in the retail markets, including core capital deferred shares (CCDS).

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## Who does this consultation affect?

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

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<sup>1</sup> We are able to make temporary product intervention rules without prior consultation. These rules may last for a maximum of 12 months. Our announcement on the introduction of temporary rules for CoCos is available at: <http://www.fca.org.uk/static/documents/temporary-product-interventions/restrictions-in-relation-to-the-retail-distribution-of-cocos.pdf>

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## Context

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- 1.4** In August 2012 we consulted on rules to protect ordinary retail investors (i.e. retail investors who are neither high net worth nor able to demonstrate sophisticated understanding of an investment) from receiving marketing communications promoting investment in non-mainstream pooled investments (NMPs).<sup>2</sup> NMPs comprise unregulated collective investment schemes (UCIS), traded life policy investments and other close substitutes.<sup>3</sup>
- 1.5** The rules were introduced on 1 January 2014 and are designed to reduce the risk of consumer detriment from the inappropriate promotion of particular risky, complex products to ordinary retail investors. Generally speaking, ordinary retail investors should not receive promotions of NMPs. Before approving or communicating a promotion relating to any of these products, firms must check that the intended individual recipient meets the criteria in one of the available exemptions.
- 1.6** This paper builds on that approach and aims to add further consumer protections by limiting the retail distribution of complex, unusual and/or risky investments in relation to retail investors who are neither sophisticated nor high net worth.

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## FCA statutory objectives

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- 1.7** The proposals are mainly designed to advance our objectives of securing an appropriate degree of consumer protection.
- 1.8** We consider that our proposals secure an appropriate degree of consumer protection by preventing the distribution of certain investments to consumers for whom they are unlikely to be suitable.
- 1.9** We also consider that our proposals are consistent with our objective to promote effective competition in the interests of consumers. By restricting the ability of firms to distribute the investments to the retail consumers for whom they are likely to be unsuitable, we believe the rules will prevent competition becoming focused on unsuitable sales, which would not be in the interests of consumers.

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## Summary of our proposals

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- 1.10** The UK market for the regulatory capital instruments that are the subject of this consultation is still fairly new. Nevertheless, these securities may be issued in large amounts over the coming months and years as banks and building societies transition their capital position to meet the new prudential requirements under the Capital Requirements Directive IV (CRD) and Capital Requirements Regulation (CRR) package of measures.
- 1.11** We regard CoCos and common equity tier 1 (CET1) share instruments issued by mutual societies as posing particular risks of inappropriate distribution to ordinary retail customers. We have been working with issuers for some time while developing our policy approach and a significant amount of our supervisory resource has been directed at this issue.

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<sup>2</sup> These rules are set out in COBS 4.12.

<sup>3</sup> Other close substitutes to UCIS include qualified investor schemes (which have always been intended solely for sophisticated investors) and non-mainstream investments structured as special purpose vehicles.

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## CoCos

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

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## Mutual society shares

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- 1.17** The mutual society instruments of concern to us in this paper are also relatively unusual, complex and risky, and pose a significant risk of inappropriate distribution to non-sophisticated investors.
- 1.18** In this paper, references to 'mutual society share' are intended as reference to core capital instruments and not to other building society instruments or arrangements often described as 'shares', some of which are deposit-based.<sup>4</sup> Mutual society shares are deeply subordinated and perpetual instruments, and often offer poor liquidity. Income payments are typically capped and always discretionary, and investors do not have the usual rights of holders of company shares, such as voting in proportion to shareholding. The most recent mutual society share issuance has taken the form of CCDS, but slightly different forms may also be issued. As with CoCos, we are concerned that these securities are hard for investors to value and that their features may not fit naturally with the needs of ordinary retail investors.
- 1.19** While recognising the risks, we are also mindful that mutual societies, particularly the smaller societies, may have little or no access to institutional markets to raise regulatory capital. We also recognise that the concept of mutuality entails ownership by members; some consumers may genuinely wish to support mutual societies of which they are members by providing core capital.

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

- 1.20** With this in mind, we are proposing to impose certain requirements on the distribution of mutual society shares to ordinary retail investors. We propose that firms may distribute the securities to investors who receive specific risk warnings and who commit to not invest more than they can afford to lose, which we propose to define as 5% of their net investable assets, in this type of security. The rules we are proposing would apply only to the primary issuance and not to secondary market dealings. However, we may reconsider this position if we find that firms are using secondary market sales as a way of getting around the rules.
- 1.21** We welcome feedback on whether our proposals achieve an appropriate and proportionate balance.

### Equality and diversity considerations

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- 1.22** We consider that the investments on which we are consulting may carry particular risks for some people with protected characteristics under the Equalities Act 2010. The elderly and those with learning difficulties or mental capacity limitations may be disproportionately vulnerable to the risk of inappropriate distribution.
- 1.23** To mitigate this risk, we are proposing a risk-based approach that allows firms to distribute investments to high net worth and sophisticated investors for whom the products are more likely to be appropriate but that protects other retail investors from the risk of entering into inappropriate transactions.

### EU considerations

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- 1.24** We consider our approach to be consistent with relevant EU legislation, including MiFID, the Prospectus Directive and the CRD IV/CRR.
- CoCos and mutual society shares are transferrable instruments under MiFID. We believe the introduction of marketing restrictions and prescribed risk warnings in the manner proposed is compatible with MiFID. The restrictions on CoCos operate as a sales restriction in relation to non-MiFID business only. For transactions and activities that are MiFID or equivalent third country business, the proposed rules on CoCos have the effect of a promotional restriction. The specification of precise terms of risk descriptions required of firms (as proposed for the distribution of mutual society shares) are explicitly permitted under MiFID. The requirement to obtain an undertaking from the prospective investor to limit the concentration of their net assets in mutual society shares would not apply in respect of MiFID or equivalent third country business.
  - Issuances of CoCos and mutual society shares may also be within scope of the Prospectus Directive. The Prospectus Directive harmonises requirements relating to prospectuses across the EEA. Our proposed rules on mutual society shares do not limit or restrict the distribution of prospectuses issued in compliance with the Prospectus Directive. We have included in our draft rules for CoCos a specific exemption allowing firms to disseminate prospectuses that are issued in compliance with the Prospectus Directive, but applying only to such prospectuses. Generally speaking, any other communication about the CoCo to which the prospectus relates (including a verbal communication, leaflets, websites or other documentation provided at the same time) would be subject to our proposed restrictions on the distribution of CoCos if directed at retail investors. We believe such restrictions are compatible with the Prospectus Directive.

- CRD IV sets prudential requirements with which institutions must comply. The CRR includes provisions concerning CoCos and certain types of mutual society capital instruments. We believe our proposed rules are compatible with the aims and objectives of CRD IV and the CRR.
- 1.25** We have also considered the recent publications by the European Supervisory Authorities (ESAs) with regard to CoCos and the self-placement of financial instruments.
- On 31 July 2014, ESMA published a statement directed to institutional investors. The statement outlines concerns that risks involved with investment in CoCos were being misunderstood or overlooked.<sup>5</sup> It also highlights the difficulties presented for investors in assessing and pricing the risks, and recommends careful consideration before investment.
  - On the same day, the Joint Committee of the ESAs published a reminder to financial institutions about the applicable regulatory requirements when financial institutions sell to their own client base financial instruments that they themselves have issued.<sup>6</sup>

### Next steps

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#### What do you need to do next?

- 1.26** We want to know what you think of the proposals on which we are consulting. Please send us your comments by 29 January 2015. To submit a response, please use the online response form on our website or write to us at the address on page 2.

#### What will we do?

- 1.27** We will consider your feedback and intend to publish our rules in a policy statement in the summer of 2015. We aim to have permanent rules in place by 1 October 2015 when the temporary product intervention rules for CoCos expire.
- 1.28** We plan in the future to review these rules and those that apply distribution restrictions to other products (such as NMPIs) to assess any scope for simplification and to ensure rules imposing restrictions on distribution are aligned with each other and provide a proportionate and appropriate regulatory response to the various issues covered.

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<sup>5</sup> [www.esma.europa.eu/content/Potential-Risks-Associated-Investing-Contingent-Convertible-Instruments](http://www.esma.europa.eu/content/Potential-Risks-Associated-Investing-Contingent-Convertible-Instruments)

<sup>6</sup> [www.esma.europa.eu/content/Placement-financial-instruments-depositors-retail-investors-and-policy-holders-Self-placemen](http://www.esma.europa.eu/content/Placement-financial-instruments-depositors-retail-investors-and-policy-holders-Self-placemen)

## 2. Distribution restrictions for CoCos

- 2.1** In this chapter we outline our proposals for permanent restrictions to the retail distribution of CoCos, to replace the current temporary rules with effect from 1 October 2015.

### Background

- 2.2** CoCos are hybrid capital securities designed to absorb losses when the issuer's regulatory capital reserves falls below a certain level. They are risky and highly complex instruments that may be issued in large amounts by financial institutions such as banks and building societies as a result of new regulatory requirements.
- 2.3** CoCos help inhibit risk transfer from investors to taxpayers. That is, in times of financial stress for the issuer, it is intended that investors should bear the costs of recapitalisation without the need for recourse to public funds. This is an important role, but highlights a particular concern from a conduct perspective: CoCos are not designed to meet an identified need of target market investors. Their design is largely dictated by requirements for regulatory capital. Many of their characteristics are highly unusual and largely untested, which means the risk/benefit ratio may operate in ways even sophisticated investors do not expect. Features that relate to the issuer's ongoing capital position may be opaque in their operation and risks. Furthermore, risks to investors that flow from the possibility of the issuer's exercise of discretion are extremely difficult to evaluate.
- 2.4** A particularly important distinction is between Additional Tier 1 (AT1)<sup>7</sup> and Tier 2 (T2)<sup>8</sup> CoCos. Broadly, T2 CoCos generally offer a fixed income and a fixed term. AT1 CoCos are non-equity irredeemable securities, offering a capped but entirely discretionary income.
- 2.5** There is a great deal of variability in the terms of these instruments. Upon a trigger event (depending on the capitalisation levels of the issuer) and as defined in the provisions governing the instrument, AT1 and T2 CoCos may be converted into shares in the issuer, or written down (temporarily or permanently). Some CoCos are completely written off if the trigger point is reached. Others may have multiple triggers instead of just one. For CoCos which convert into shares, different rates of conversion may apply and the shares may be denominated in a different currency to the CoCos.
- 2.6** Overall, these securities present very complex features that make them extremely difficult to value, even for professional investors.

<sup>7</sup> Tier 1 represents 'going concern' loss-absorbing capital for banks and building societies. It is subdivided into core equity tier 1 capital, including share (core equity tier 1) capital and retained profits, and additional tier 1 capital. The main characteristics of AT1 instruments are: there should be no contractual obligation to pay dividends or interest to investors with the deferral of a coupon usually being at the option of the issuer; deferred coupons or dividends are non-cumulative; instruments should be able to absorb losses before, or instead of, general creditors; and instruments must be perpetual.

<sup>8</sup> The main characteristics of T2 debt are: perpetual investments, senior to Tier 1 preferred and equity; coupons are deferrable and cumulative; interest and principal can be written down.

- 2.7** In August this year we announced that we had used our temporary product intervention rule-making power for the first time, introducing rules that restrict the retail distribution of these instruments unless firms first check that the client meets certain criteria. The temporary rules came into force on 1 October 2014 and will expire on 1 October 2015. We are now proposing to make this approach permanent.
- 2.8** Before announcing the temporary rules, we worked closely with UK issuers to ensure the new securities are marketed in a way that minimises the risk of inappropriate investment by ordinary retail investors. This interim approach was largely achieved through voluntary agreement by issuers of high minimum denomination values.
- 2.9** We believe the marketing restriction approach offers firms more transparency and consistency, while securing stronger consumer protections. We do not expect denomination sizes to drop too far as a result of the change in regulatory approach, however. Issuers are themselves subject to the proposed rules and must not distribute CoCos to ordinary retail investors. Distribution strategies which target ordinary retail investors, such as CoCos issued in small, retail-sized denomination values, or distribution via mass-market intermediaries, are unlikely to be compatible with issuers' obligations under the proposed rules.

### Risks for investors

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- 2.10** In this section we set out some of the principal risks facing CoCo investors. Given the complexity of these products, we consider that ordinary retail investors are unlikely to be able to understand or evaluate these investment propositions.
- 2.11** Pricing CoCos is challenging even for professional investors and requires evaluation of complex risk factors, such as:
- The likelihood that the issuer's capital reserves will change over time so as to trigger a conversion or writing down event. This requires having regard not only to potentially transparent but technical factors, such as the issuer's credit spread, leverage and rating of the instrument (if any), but also individual regulatory requirements relating to capital buffers and future risks to the issuer's capital position, which may not be known to investors.
  - The extent of any losses upon trigger conversion. For equity conversion CoCos, this involves considering the risk of unfavourably-timed conversion into shares, unfavourable currency exchange rates (if the shares are denominated in a different currency to the CoCo) and, more generally, unfavourable conversion terms. For write down CoCos, this includes whether the CoCo is partially written down or completely written off, and whether such writing down or off is permanent or temporary.
  - Whether the note is permanent or dated, whether the income payments or 'coupons' are discretionary or fixed, and the degree of subordination of the instrument. If the instrument is a permanent note, the issuer has no obligation to repay investors' capital. In this sense the instruments are like shares, but investors holding them do not enjoy the rights of shareholders and have no say in the running of the business, including decisions that may affect their investment.
  - For CoCos written to an AT1 template, the likely behaviour by the issuer in relation to 'coupon' payments, which is inherently difficult to estimate. This includes consideration of the likelihood of cancellation of coupons, and whether such cancellation may be temporary,

longer term or permanent. Discretionary coupon payments may be stopped at any time, possibly even if the issuer is not experiencing financial stress, and even if shareholders continue to receive dividends.

- Potential contagion risks are also a consideration, in particular for AT1 CoCos. For example, if one issuer decides to cancel 'coupon' payments for their issues, it may affect the value and liquidity of similar instruments from other issuers across the market.
- Liquidity risks. CoCos are currently relatively illiquid because of their complexity and relatively small secondary market. It is uncertain how this secondary market will develop. Investors may not be able to sell their security when they want or need to, or at a reasonable price.

**2.12** In its statement of 31 July 2014, ESMA also expressed the view that analysis and evaluation of the risk factors of CoCos 'can only take place within the skill and resource set of knowledgeable institutional investors'.

**2.13** These instruments are designed to meet the capital needs of issuers. They are not investment products designed to meet the needs of investors. However, CoCos tend to offer relatively high 'coupon' rates, which can easily catch the eye of investors, particularly in the present low interest rates environment. Ordinary retail investors are at a particular risk of inappropriate investment.

**2.14** Generally speaking, we view CoCos primarily as investments for the institutional markets. We consider that these securities are highly unlikely to be suitable investments for ordinary retail investors. However, we expect that retail investors who are sufficiently sophisticated will be better placed to evaluate the risks and complexity involved. Similarly, high net worth investors are better placed to afford specialist advice and absorb any losses.

## Proposals

### Distribution restrictions

**2.15** As with the temporary rules, the rules on which we are consulting apply to all authorised persons in the UK, including both issuers of CoCos and firms promoting or intermediating transactions in CoCos. The proposed rules would apply even if there is no client relationship between the firm and the retail investor (as may be the case in relation to sales by the issuer, for example).<sup>9</sup>

**2.16** The proposed rules would have no effect in relation to the distribution of CoCos to professional or institutional clients. The rules would not restrict the distribution of prospectuses issued in compliance with the Prospectus Directive, and would not apply to clearing, registration, settlement, custodial or back office processing services.

**2.17** In relation to retail investors, the proposed rules generally do not permit firms to sell, promote or intermediate transactions in CoCos that would result in ordinary retail investors in the European Economic Area (EEA) investing in CoCos. However, to the extent a firm's activities amount to MiFID or equivalent third country business, the proposed rules would only apply restrictions in relation to promotional activities and not to the sale or intermediation of the transaction in CoCos.

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

- 2.18** Firms engaging in MiFID or equivalent third country business are reminded that compliance with the restrictions on promotion introduced by the temporary rules does not exhaust their regulatory responsibilities. Their duties under the client's best interest rule (COBS 2.1.1R) as well as the suitability (COBS 9) and appropriateness (COBS 10) rules are particularly relevant in the context of intermediation of transactions in CoCos for retail clients. Given the exceptional complexity and significant risks of CoCos, firms may find that these investments are not appropriate for any but the most sophisticated of retail investors, and may be suitable only as a modest element of large portfolios held by investors who are both high net worth and sophisticated.
- 2.19** Whether or not the activities amount to MiFID or equivalent third country business, a number of exemptions are provided in relation to the proposed restrictions. Subject to conditions, firms may sell, promote or intermediate transactions in CoCos (as the case may be) if the retail investor is certified as a high net worth investor, sophisticated investor, or self-certified sophisticated investor, or if the consumer has specifically requested advice without receiving previous communications from the firm about investment in CoCos.
- 2.20** Firms are reminded of our existing rules and guidance in COBS 2.4 on treating agents as clients and on reliance on information provided by other persons. A firm is generally able to treat as a client another firm acting as agent for an end client. In addition, a firm can generally rely on information about the end client given to it by a MiFID investment firm or investment firms subject to equivalent relevant requirements. Even where the intermediary firm is not acting as agent for an end client, a firm may generally rely on information provided in writing by another person in determining whether they comply with the rules, provided it can show such reliance is reasonable.
- 2.21** Following the announcement of the temporary product intervention rules, we have been asked about our expectations of issuers or underwriters / book runners working with non-UK distributors selling securities to consumers elsewhere in the EEA. The temporary rules require firms to take reasonable steps to ensure an exemption applies when they are involved in sales to retail investors. A measure of flexibility is therefore envisaged under the temporary rules (and retained in the proposed rules).
- 2.22** For instance, it may be reasonable for an issuer or underwriter to deal with non-UK EEA distributors that have slightly different but broadly equivalent ways of assessing whether customers are high net worth or sophisticated, such that the requirements of the relevant exemptions are met in substance.<sup>10</sup> We have amended the proposed rules relative to the temporary rules so as to explicitly allow for this.
- 2.23** Another way in which issuers and underwriters may be able to demonstrate that they have taken reasonable steps when dealing with EEA sales is by issuing the notes in high denomination values or otherwise requiring a high minimum investment from each investor so as to sufficiently minimise the risk of investment by ordinary retail investors. Firms would also be able to rely on representations from third parties that there would be no distribution to ordinary retail investors (provided such reliance is permitted under COBS 2.4).
- 2.24** Finally, if the activity in scope of the temporary rules is being carried on in the course of providing a MiFID investment service, the firm is exempt from the marketing restriction other than in respect of the approval or communication of a financial promotion. We expect this is likely to be the case for most underwriters / book runners.

<sup>10</sup> UK distributors are themselves subject to the rules. It is unlikely that sales/promotion to retail clients assessed as high net worth or sophisticated according to criteria that would not meet the requirements in our rules would amount to 'reasonable steps' for such firms.

**2.25** Neither the temporary rules nor the proposed permanent rules create an obligation for firms to review existing retail holdings of CoCos. However, if firms identify problems or compliance failures, we expect them to have regard to Principle 6 (a firm must pay due regard to the interests of its customers and treat them fairly) and consider whether they ought to act on their own initiative regarding the position of existing customers who may suffer detriment from, or be potentially disadvantaged by, such failures.

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

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

**2.26** Where firms sell, promote or intermediate CoCo transactions in the retail market, we also propose that firms must make a record of the basis on which the sale, promotion or other intermediation activity is made, including any signed statement from the investor.

**2.27** We propose that the firm's compliance department must also check that the sale, promotion or other intermediation activity complies with the marketing restriction. If the compliance department's confirmation is delegated, the person responsible for compliance function oversight in the firm must review the approval process on at least an annual basis.

**2.28** Where firms sell, promote or intermediate CoCo transactions relying on the sophisticated or high net worth individual exemptions, the rules we are consulting on would require the firm to give the client a written copy of the relevant statement signed by the individual.

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

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

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

#### **Pooled investment in CoCos**

**2.29** We also propose to apply the same requirements as set out above to investment funds that invest wholly or predominantly in CoCos and which are not retail-oriented regulated funds. CoCo funds within scope of the proposed rules could be structured as unregulated collective investment schemes, qualified investor schemes or as special purpose vehicles. In relation to sales which are not transacted as MiFID or equivalent third country business, the proposed rules operate as a sales restriction for NMPs which are CoCo funds.

**2.30** While pooling can help reduce risk, an investor in a scheme or investment vehicle that invests predominantly in these securities would be exposed to significant risks, including unusual exposure to contagion risks. We believe such investment funds should be subject to the same restrictions.

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

**Types of distribution not affected by the proposals**

- 2.31** The rules lead to changes only in relation to retail investment. The proposals have no impact on distribution to other types of customer, such as professional clients or eligible counterparties.
- 2.32** We have also included exemptions to the rules for issuers and firms providing clearing, custodial and processing services. These exemptions mean the proposed permanent rules do not prevent firms undertaking essential services in relation to trading.
- 2.33** The proposed rules also do not apply to most types of indirect investment, such as investment via funds (other than certain funds investing wholly or predominantly in CoCos) or discretionary investment management portfolios by MiFID investment firms (provided there has been no promotion). However, where a MiFID investment firm purchases a CoCo for a client as part of a discretionary investment management service for a customer to whom the firm could not promote the instrument under the marketing restrictions, it should exercise particular care to satisfy itself that the transaction is suitable for the client and that it is in that client's best interests, noting in particular that in our view CoCos are unlikely to be suitable investments for the vast majority of retail clients.
- 2.34** Insurance-based investments should not be caught by the proposed rules (or indeed by the temporary rules that came into force on 1 October 2014) because investors' rights arise out of contract rather than as beneficial interests in the investment assets held by the insurance company to meet its liabilities.
- 2.35** The rules do not restrict advice on the ongoing suitability of an investment that a customer already owns. Advice to keep a current investment unchanged or to disinvest in favour of a more suitable investment would not be caught by the proposed restrictions. However, a recommendation or promotion for further investment into a CoCo would be subject to the restrictions.
- 2.36** We are not proposing to provide an exemption for distribution to "exempt persons" in the proposed permanent rules for CoCos. It seems to us that such persons are unlikely to be retail investors or to be promoted or sold CoCos, but we would be interested in feedback from respondents if they believe the exemption is necessary.

**Guidance on suitability and on the classification of retail clients as sophisticated for the purpose of investment in loss-absorbing regulatory capital**

- 2.37** We are proposing to amend the existing Handbook Guidance in COBS 9.3.5G to reflect the wider application of that guidance in relation to assessing suitability of investments to which a restriction on distribution applies.
- 2.38** We are also consulting on introducing Handbook Guidance about the requisite level of investment experience and understanding before an investor may be certified as sophisticated in relation to these instruments.
- 2.39** Given the risks identified above, we consider that the only investors capable of being assessed as sophisticated for these instruments would be those with extensive experience in multiple types of complex financial instruments and who have sufficiently in-depth understanding of how banks and building societies are run, including how their prudential position is assessed and the types of risks banks and building societies may face in maintaining the necessarily levels of regulatory capital.

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

## 3. Distribution restrictions for mutual society shares

- 3.1** In this chapter we outline our proposals for restrictions to the retail distribution of CET1 capital instruments issued by mutual societies.

### Background

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- 3.2** Mutuality precludes mutual societies from raising capital by way of issuing ordinary equity shares, such as those generally issued by companies. Under the CRR, mutual societies that are credit institutions are able to issue regulatory capital instruments that will qualify as CET1 capital. Like CoCos, these instruments are not created to meet a consumer need; the focus is on the issuer's prudential requirements.
- 3.3** While it is not always the case, members of mutual societies may sometimes contribute money to the society without the expectation of a profit. Instead, the money may be seen as a contribution, which may or may not be repaid, made in support of the society's aims. The securities we are concerned about are those issued by mutual societies that act as credit institutions and which are likely to be offered to members as investments. Research over the years has found that the average retail customer faces significant challenges when trying to understand and evaluate investments.<sup>11</sup> Mutual society members tend to represent a cross-section of the public and we expect many will have little or no experience with investments other than deposit-based products.
- 3.4** The most recent mutual society share issuance has taken the form of CCDS, but different forms may also be issued, with one example being profit-participating deferred shares (PPDS).<sup>12</sup>
- 3.5** To date, FCA supervisors have been working closely with issuers to ensure mutual shares designed to CRR specifications are not offered to ordinary retail investors. This has been achieved largely through voluntary agreement by issuers to high minimum denomination values for the notes. We intend to continue our case-by-case approach for proposed issuances, seeking voluntary agreement of minimum denominations while we consult on a new approach, and until the final rules are introduced.

<sup>11</sup> See for instance *Levels of financial capability in the UK: results of a baseline survey*, prepared for the Financial Services Authority by Personal Finance Research Centre, University of Bristol, March 2006: [www.fca.org.uk/static/fca/documents/research/fsa-crpr47.pdf](http://www.fca.org.uk/static/fca/documents/research/fsa-crpr47.pdf). See also *Financial capability: a behavioural economics perspective*, prepared for the Financial Services Authority by David de Meza, Bernd Irlenbusch and Diane Reyniers of the London School of Economics, July 2008: [www.fca.org.uk/static/fca/documents/research/fsa-crpr69.pdf](http://www.fca.org.uk/static/fca/documents/research/fsa-crpr69.pdf) and *Applying behavioural economics at the Financial Conduct Authority*, April 2013: [www.fca.org.uk/static/documents/occasional-papers/occasional-paper-1.pdf](http://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-1.pdf).

<sup>12</sup> We will continue to monitor discussion of the proposed Mutuals Redeemable and Deferred Shares Bill and take account of its development, where relevant for the matters under discussion in this paper.

- 3.6** Given the need for mutual society credit institutions to be able to raise capital, and given the current low interest rate environment, we consider there to be a risk that, in the absence of regulatory action, these securities may be promoted broadly to retail investors searching for yield, in particular savers. As with CoCos, we are concerned that these securities may be hard for investors to evaluate, and that their features may not fit naturally with the needs of ordinary retail investors.

### **Risks for investors**

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- 3.7** While features can vary from issue to issue, mutual society shares can carry high levels of risk. Mutual society shares are perpetual, deeply subordinated capital instruments with fully discretionary distributions that are typically capped. Typically they offer poor liquidity, with limited secondary markets at present, meaning investors may not be able to sell their securities if they need cash, or find that they can only sell them at far-reduced values. Due to their novelty, there is also limited historical performance information available to investors on these securities. Investors do not have the usual rights of company shareholders, such as voting in proportion to shareholding.
- 3.8** Should a society become insolvent, shareholders would stand last in line in the order of repayment. Shares of any kind are not covered by the Financial Services Compensation Scheme, though advice and financial promotions relating to shares are generally covered.
- 3.9** Though many of these risks are similar to those applicable to direct investment in company shares, it is worth noting that direct investment in shares is generally risky. Retail-oriented investment in shares generally takes the form of indirect investment via regulated investment funds, where investors benefit from participation in a large, professionally-managed portfolio which is diversified for a prudent spread of risk.
- 3.10** Our concerns are not solely linked to the share capital instruments' features, but primarily relate to the possible targeting of ordinary retail investors, in particular savers and mortgage borrowers, who generally constitute the bulk of membership of mutual societies. We are concerned that direct investment in shares presents risks that many mutual society members may not be familiar with, and that may be easily underestimated or misunderstood. We are also concerned about possible distribution strategies that play on consumer behavioural biases and weaknesses, such as information asymmetry and consumers' natural tendency to focus on headline rates of return when faced with relatively complex propositions.
- 3.11** Given the current low interest rates environment, we consider there to be a particular risk that unwary deposit-holders, focused on initially higher rates of return, may mistake or misunderstand the nature and risks of mutual society shares. Regardless of their design, these shares may be seen by savers as relatively safe, fixed income investments and as potential alternatives to deposit-based products.

## Proposals

### Distribution requirements

- 3.12** While recognising the risks of inappropriate distribution in the retail market, we are mindful that mutual societies, particularly the smaller societies, may have little access to institutional markets to raise regulatory capital. To provide a proportionate response to the identified risks, we are proposing new requirements applying to the distribution of mutual society shares that are less restrictive than for CoCos and allow distribution to ordinary retail investors, subject to certain safeguards. We believe compliance with the requirements will make competition work more effectively for consumers by minimising scope for sales that exploit consumer biases and the limited investment experience of the average saver. The prescribed risk warnings and investor certification should focus consumers' minds on the key characteristics and risks of mutual society shares and help them make informed decisions about whether to buy these investments.
- 3.13** Our proposed rules are intended to capture all capital instruments issued by mutual societies (and equivalent EEA entities) that are eligible as CET1 capital under the CRR. We expect the majority of these instruments in the UK to be building society deferred shares, but other types of shares may be designed and issued by other types of mutual societies to raise capital. Such instruments, if eligible under the CRR, would also be caught.
- 3.14** Our proposed rules are intended to apply only to sales in the primary market, where we see the most risk of inappropriate distribution. Transactions in the secondary market would be unaffected. That is, the retail distribution of newly-issued securities will be subject to new requirements but, at this point, we are not proposing to apply the rules to re-sale transactions.
- 3.15** We consider that this is a proportionate approach, consistent with our assessment of the risks. We are interested in comments on whether we have struck the right balance.
- Q8: Do you believe we should subject all mutual society shares to the same distribution restrictions as CoCos or do you consider there is a need to allow the wider retail distribution of mutual society shares?**
- Q9: Alternatively, do you believe applying to CoCos the same approach as proposed for mutual society shares would achieve an appropriate degree of consumer protection?**
- Q10: Do you believe secondary market transactions should be subject to the same rules as primary market sales?**
- 3.16** The proposed rules permit distribution of mutual society shares to professional and eligible counterparty clients without restriction. They would also permit distribution to retail investors classed as certified sophisticated investors,<sup>13</sup> self-certified sophisticated investors,<sup>14</sup> and certified high net worth investors.<sup>15</sup>

<sup>13</sup> These are retail clients with extensive investment experience and knowledge, who are better able to understand the risks of complex and unusual investments.

<sup>14</sup> To self-certify as sophisticated, a client must, among other factors, meet one of four criteria demonstrating their investment experience.

<sup>15</sup> Among the criteria such clients must meet are having an annual income of more than £100,000 or having investable net assets of more than £250,000. Net investable assets exclude the value of the client's home, pension funds and any benefits under insurance policies. Any debt the client owes should be subtracted from the value of assets held by the investor.

- 3.17** For other clients (i.e. ordinary retail clients), our proposed rules would permit distribution where the firm provides specific risk warnings.
- 3.18** The proposed warnings cover the following:
- all of the capital invested is at risk
  - income or distribution payments are entirely discretionary
  - the instrument is perpetual and may be illiquid
  - investing more than 5% of the client's net investable portfolio in this type of instrument is unlikely to be in their best interests
- 3.19** To demonstrate that these risk warnings have been read and understood, we propose that clients must sign to acknowledge them.<sup>16</sup>
- 3.20** In addition, a further proposed requirement would apply to non-advised sales which are not MiFID or equivalent third country business: the firm would be required to obtain from the retail client an undertaking to limit their investment in mutual society shares to 5% of their net investable assets.<sup>17</sup>
- 3.21** We expect that the effect of the proposals would be that consumers who decide to invest in these securities would have at least a basic awareness of the risks involved, and would only invest money they can afford to lose.
- 3.22** We are not proposing that firms take responsibility to assess whether or not clients make good on the commitment not to invest more than 5% of their net investable assets. The approach we are introducing relies on self-certification by the client. Consumers must take responsibility if they choose to invest more than this proportion of their assets.
- 3.23** There is nothing in the proposed rules which prevents these requirements from being fulfilled via electronic means, for instance, via the use of electronic signatures where appropriate.
- 3.24** We note that some mutual societies in other jurisdictions have offered similar securities to their members but with a fixed maximum investment amount per investor. Our proposal takes a similar approach, recognising a desire for retail clients to provide financial support for a society's aims, but in a way that caps the maximum risk they are taking with their money.
- 3.25** We are also proposing to extend the appropriateness test to non-advised sales that do not amount to investment services provided in the course of MiFID or equivalent third country business, as a further safeguard. Firms carrying on non-advised sales of mutual society shares outside of MiFID scope would need to satisfy themselves that the retail investor is likely to have the requisite experience and knowledge to understand the risks involved in relation to investment in mutual society shares. This requirement would apply where that same transaction would be subject to the appropriateness test if it was MiFID or equivalent third country business.<sup>18</sup> Where

<sup>16</sup> There is no requirement for an ink signature: the client confirmation exercise may be completed online. We expect firms to provide retail clients with the risk warnings and investor statement in separate and distinct documents which the client can focus on.

A signature acknowledging that a client has read a document that includes the required risk warnings as part of a broader set of provisions is unlikely to demonstrate compliance with the proposed rules.

<sup>17</sup> Net investable assets exclude the value of the client's home, pension funds and any benefits under insurance policies. Any debt the client owes should be subtracted from the value of assets held by the investor.

<sup>18</sup> As with the client's confirmation that they have read and accept the risk warnings, the appropriateness test may be completed with an electronic signature.

a firm carrying on MiFID or equivalent third country business would not need to apply the appropriateness test, we do not propose to require it for firms carrying on non-MiFID business.

**3.26** At present, even listed mutual society shares may be complex instruments under MiFID criteria: the instruments may be illiquid (at least initially, as the market develops) and may lack publicly available and adequately comprehensive information that is likely to be readily understood to enable the average retail client to make an informed judgment about whether to invest. Unlisted mutual society shares would generally be complex instruments. Therefore, we would generally expect many if not all non-advised, MiFID-scope retail sales to be subject to the appropriateness test. The effect of the proposal would be to level the playing field and extend this consumer safeguard to transactions outside MiFID scope, to which COBS 10 would not otherwise apply.

**3.27** The proposed approach to the distribution of mutual society shares has similarities to the 'restricted investor' category for non-readily realisable securities sold on investment-based crowdfunding platforms, as set out in COBS 4.7.10R. There are important differences, however:

- The proposed rules are not limited to direct offer promotions as applicable for the rules on investment-based crowdfunding, and instead have broad applicability to sales of mutual society shares (as with CoCos).
- Another difference is that our proposed rules would require prescribed risk warnings specific to mutual shares, and require investors to certify that they will abide by a 5% limit, rather than the 10% limit applied to the 'restricted investor' category in COBS 4.7.10R. We propose this lower limit to recognise the different way in which mutual society shares are likely to be sold. Investors on crowdfunding platforms currently tend to be relatively experienced and typically will proactively search out opportunities in the platform services. On the other hand, mutual society members are more likely to be inexperienced investors who may passively receive promotional communications for mutual society shares.

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

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

**3.28** We also propose that firms must keep a record demonstrating compliance with the requirements on distribution on the sale of mutual society shares to retail investors. Such records would either be made by or checked by the person allocated the compliance oversight function in each firm, who would also be required to review the approval process on at least an annual basis. We regard this process as a sensible precaution to ensure the requirements are met for each sale, and to guard against the improper use of the exemptions, for example retrospective or unsupported classification of clients as sophisticated or high net worth.

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

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

**Q15:** Do you agree that the person responsible for compliance function oversight in the firm must review the approval process for compliance confirmation on at least an annual basis?

**Activities not affected by the proposals**

**3.29** The rules proposed in relation to mutual society shares do not affect distribution to non-retail customers, indirect investment, advice about the ongoing suitability of an existing investment (only advice to invest more money is caught) and clearing, custodial and processing services.

## 4. Existing investors

- 4.1** In this chapter we summarise the position for retail investors with existing exposure to the investments subject to this consultation and the firms that advise these consumers.

### Distributor firms

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- 4.2** Distributor firms might be concerned that the proposed changes to the rules mean they cannot provide ongoing advice to retail customers who already have exposure to one of the investments covered in this consultation. This is not the case.
- 4.3** The proposed rules are drafted to permit advice on the ongoing suitability of an investment that a customer already owns. Advice to keep a current investment unchanged or to disinvest in favour of a more suitable, more mainstream investment would not be caught by any of the proposed rules. However, a recommendation for further exposure to one of the investments subject to this consultation (including an existing investment) would be subject to the proposed rules.

### Existing investors

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- 4.4** Consumers who already have exposure to one of the investments subject to this consultation may want to consider their next steps.
- 4.5** For existing investors who invested following advice, the person who gave them advice should be able to explain why they thought the investment was suitable.
- 4.6** Consumers who invested without advice may wish to seek independent advice on the investment and on what their options might be. If they no longer think the investment is right for them, they should speak to a financial adviser to discuss their options.
- 4.7** If customers believe they were mis-sold the product, for instance as a result of unsuitable advice or of misleading promotional literature, they should contact the firm that arranged the investment for them and raise their concerns. The firm should have a procedure to follow to resolve matters. If the customer is not satisfied with the answer or proposed resolution, they can take the complaint to the FOS.<sup>19</sup>

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<sup>19</sup> We expect the number of retail investors currently invested in CoCos or mutual society shares to be quite limited. However, there might still be some retail investors who feel that these securities were mis-sold to them.

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

# Annex 1

## Cost benefit analysis

### The market

#### CoCos

1. Between 2009 and 2013, the amount of CoCos issued by banks globally is estimated to have reached around \$70bn (approximately £40bn) of which approximately 80% was issued by European banks.<sup>20</sup> 20.7% of the global issuance of CoCos has been from UK banks.<sup>21</sup>
2. In the June 2014 *Financial Stability Report*,<sup>22</sup> the Bank of England noted that European issuance of AT1 has accelerated sharply over the past 18 months. The report estimated that, if the largest four UK banks issued AT1 up to 1.5% of risk-weighted assets, this would lead to additional issuance of around £22bn (around £7bn has been issued to date).
3. The Royal Bank of Scotland estimated that large European banks need to issue €40bn (approximately £30bn) of Tier 1 capital in order to comply with Basel III standards.<sup>23</sup> In a report earlier this year, Bank of America Merrill Lynch estimated the European AT1 CoCo market could grow to more than €150 billion (approximately £120 billion) by 2020.<sup>24</sup> Assuming future UK issuance continues to account for 26% of the European market, the UK CoCo market may grow to £31.2bn by 2020 at an average rate of around £2bn to £4bn per annum, if the market grows at a constant rate.
4. In our work to assess the costs and benefits of our proposals on the market, we will use two estimates to show a range of outcomes. We consider the effect if the top five banks (which together account for almost two-thirds of retail savings in the UK)<sup>25</sup> were to issue CoCos in the coming years. We also consider the situation if ten banks were to issue CoCos.
5. Most CoCo securities issued to date appear to be for issuance sizes of around £1bn, though some issues have been for over £5bn.

#### Mutual society shares, including CCDS

6. We are proposing rules that will apply to the retail distribution of these securities in the primary market. The rules will not, therefore, affect the distribution of existing securities already trading on the secondary market.

<sup>20</sup> CoCos: a primer, BIS Quarterly Review, September 2013, Bank of International Settlements, [www.bis.org/publ/qtrpdf/r\\_qt1309f.pdf](http://www.bis.org/publ/qtrpdf/r_qt1309f.pdf)

<sup>21</sup> This means UK bank issuance accounts for approximately 26% of the issuance by European banks.

<sup>22</sup> *Financial Stability Report*, issue 35, June 2014, Bank of England, [www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf](http://www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf)

<sup>23</sup> RBS, *Coco Loco: The systemic risks of contingent capital*, 14 April 2014

<sup>24</sup> Bank of America Merrill Lynch, *Contingent Capital – what we think*, 14 January 2014

<sup>25</sup> Mintel, *Deposit and Saving Accounts – UK*, April 2014

7. As noted above, the most recent mutual society share issuance has taken the form of CCDS, but different forms may also be issued. There have been three PPDS issues, totalling some £250m. Some building society CoCos will convert to these instruments if they trigger in the future. Overseas mutual societies and equivalent entities may also issue a wide range of different forms of shares, any of which could be marketed to investors in the UK. Given the diversity of instruments which could be issued, we are proposing rules drafted in such a way as to catch other types of share issued by mutual societies, not just CCDS, so as to ensure consistency of treatment.
8. From our conversations with industry representatives, we believe that there may be up to five building society CCDS issuances in the next few years. To estimate a possible range of outcomes, in the following analysis we assume first that three societies issue CCDS and second that five societies issue CCDS. Based on our discussions with industry representatives, we are assuming CCDS issue sizes of between £10m (for smaller societies) and £100m (for larger societies). We therefore expect a range of issuance sizes, perhaps with more at the lower end of the range if many smaller societies decide to issue. On these assumptions, the market for mutual society shares may increase by between £100m<sup>26</sup> and £250m<sup>27</sup> by 2020 at an average rate of around £14m to £35m per annum, if the market grows at a constant rate.

### Distributors

9. We anticipate retail distribution of CoCos and mutual society shares to be primarily via two sources:
  - self-placement, under which the issuing institution promotes its own instruments directly to existing clients, members or the public (this may be more likely for mutual society shares than for CoCos)
  - specialist wealth managers, whereby the securities are distributed via third party intermediaries specialising in advisory or portfolio management services
10. To assess the impact on self-placement, we use the same estimates as above for the number of issuers (between five and ten banks and between three and five building societies).
11. From analysis of data submitted to the FCA, we estimate there are around 150 specialist wealth management firms likely to consider the promotion of these securities. To provide a range of estimates here, we have considered scenarios under which quarter of these firms (40 firms) and half of these firms (75 firms) consider promoting these instruments.
12. In total, therefore, we consider the impact of our proposals assuming there are between 48 and 90 distributor firms.

### Investors

#### CoCos

13. Given the structure and nature of these instruments, the investor profile is not tracked in the same way as for a financial product developed with a retail customer base in mind. Different estimates have been provided for the proportion of retail customers who have invested to date.

<sup>26</sup> Assuming three issues, one of £100m and two of £10m

<sup>27</sup> Assuming five issues, two of £100m and three of £10m

- Basing their estimate on a sub-sample of issues, the Bank of International Settlements reported in 2013 that the bulk of the demand (52%) was from retail investors and private banks in Asia and Europe.<sup>28</sup>
  - Other market commentators suggest that the average proportion of investment accounted for by private investors is around 20%.<sup>29</sup>
  - Information from Dealogic for some issues suggests that retail participation in some securities may be much less than this, of 2% or less.
  - We note however that in some cases issuers in other jurisdictions have used self-placement distribution models to sell similar capital instruments to their retail clients in the past. In some cases it appears that the majority of sales per issuance were to retail investors.
- 14.** To date, we have engaged with UK issuers before the issue to discuss the terms that will be offered. We have sought to agree sufficiently high minimum denominations that tend to minimise the scope for direct investment by ordinary retail investors in CoCos and limit the retail market to high net worth retail investors only, in addition to non-retail (professional and institutional) investors.
- 15.** Some non-UK CoCos may also have been sold to UK-based investors. It is likely that some of this investment has been by UK retail investors, but we expect exposure to be predominantly for high net worth and sophisticated investors known to specialist distributors.
- 16.** Based on the above market analysis and assuming the implementation of the permanent rules on which we are consulting, we estimate that the amount of money invested by UK retail customers will rise from its current level to between £624m and £6.24bn in 2020.<sup>30</sup>
- Pooled investments that invest wholly or predominantly in CoCos**
- 17.** To date we are not aware of any pooled investment vehicles (funds) that invest wholly or predominantly in CoCos. We are proposing to include rules restricting the retail distribution of such funds to guard against risks that may materialise in the future and the possibility of arbitrage (e.g. if a CoCo were to be securitised and then distributed to retail customers).
- Mutual society shares**
- 18.** The number of future retail investors in mutual society shares is likely to be much higher (though the total amount invested may be less).
- 19.** Based on our research and conversations with firms, we expect retail investors to account, on average, for between 50% and 75% of investors in mutual society shares. Larger issuers might be able to raise funds exclusively from institutional investors, without seeking any retail investment at all. For smaller issues, however, where institutional investment is less available, it may be that retail investors account for the entire investor base of certain securities.

<sup>28</sup> *CoCos: a primer*, BIS Quarterly Review, September 2013, Bank of International Settlements, [www.bis.org/publ/qtrpdf/r\\_qt1309f.pdf](http://www.bis.org/publ/qtrpdf/r_qt1309f.pdf)

<sup>29</sup> *Regulators must act on CoCo bond risks*, Financial Times, 7 May 2014, [www.ft.com/cms/s/0/dbef9b1a-cede-11e3-8e62-00144feabdc0.html?siteedition=uk#axzz31CMvKOcd](http://www.ft.com/cms/s/0/dbef9b1a-cede-11e3-8e62-00144feabdc0.html?siteedition=uk#axzz31CMvKOcd)

<sup>30</sup> These figures assume that the UK market increases to between £31.2bn in 2020 and that between 2% and 20% is held by retail investors. As noted above, we have assumed that between five and ten new securities will be issued by 2020 with an issue size of between £1bn and £5bn.

20. As with CoCos, we have adopted a regulatory approach to date that, on a case-by-case basis, seeks to agree sufficiently high minimum denomination sizes with prospective issuers. The minimum denominations we have agreed have been correspondingly lower for CCDS than CoCos to account for the particular needs of issuers in this market. To date, given the minimum denominations, UK retail exposure to CCDS is likely to be primarily from wealthier investors.
21. It is also likely that some non-UK mutual society shares will have reached UK investors, including some retail investors. As with non-UK CoCos, we expect these investors to be mostly high net worth and sophisticated investors known to specialist distributors.
22. Based on the above analysis and assuming the implementation of the rules on which we are consulting, we estimate that the amount of money invested by UK retail customers will rise to between £50m and £200m in 2020.<sup>31</sup>

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

**Market failure analysis**

23. When considering possible involvement in the market by ordinary retail investors, the principal market failures appear to be a combination of information asymmetry (investor inexperience and lack of understanding of the risks) and behavioural biases. That is, given the low interest environment at present, investors are likely to focus too much on the higher yields offered by these securities, and overlook the risks that underlie them. There is also a possibility that investors are likely to be overconfident of their ability to assess risk: for example, one survey of existing CoCo investors found that 90% of respondents rated their abilities as above average.<sup>32</sup>
24. CoCos and mutual society shares serve an important role in capitalising the financial services industry. As potential retail investments, however, they are high-complexity, higher-risk instruments that may cause problems if they reach unsophisticated retail clients, or retail clients who cannot afford specialist advice, hungry for yield.<sup>33</sup>
25. Where issuers are focused on improving their capital positions, particularly at a time when many financial institutions have to repair balance sheets and meet higher capital standards in order to guard against a recurrence of recent financial instability, these risks may be exacerbated. It may be the case that issuers turn to retail customers if institutional investors require better terms and conditions or if there is insufficient demand for any other reason.

<sup>31</sup> These figures assume that the UK market increases by between £100m and £250m by 2020 and that between 50% and 75% of this is held by retail investors. As noted above, we have assumed that between three and five new securities will be issued by 2020 with an issue size of between £10m and £100m.

<sup>32</sup> *The Revolver*, Macro Credit Research, 12 May 2014, RBS, <http://ftalphaville.ft.com/files/2014/05/The-Revolver-Cocos-Investors-call-for-standardisation-more-consistency-RBS.pdf>

<sup>33</sup> Issuers in some other jurisdictions have used self-placement distribution models to sell similar capital instruments to their retail clients in the past. In some cases it appears that the majority of sales per issuance were to retail investors the majority of whom appear to be ordinary retail clients. After the market dried up, customers could not get their initial investment back and were offered a swap of those securities for other capital instruments entailing considerable loss per customer. See, for instance: *Informe sobre Comercialización de participaciones preferentes entre clientela minorista*, *Revista de Derecho Mercantil y Financiero*, April-June 2013, <http://rdmf.files.wordpress.com/2013/10/zunzunegui-comercializacion-de-participaciones-preferentes-entre-clientela-minorista.pdf>

26. In light of these factors, our proposals focus on protecting ordinary retail investors from exposure to securities they are unlikely to understand and who are less likely to be able to cope with the capital losses that may materialise. For these customers, who are neither sophisticated nor wealthy, unexpected losses could have a very serious impact on their circumstances. In the following analysis we regard these possible life-changing losses to ordinary retail investors as a consumer detriment. The losses do not amount to detriment for other customers, who are better able to understand the risks or to afford the losses. For those investors, capital loss is a risk that the customer is prepared to take and able to afford.

### Cost benefit analysis

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27. The Financial Services and Markets Act 2000 (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. It also requires us to include estimates of those costs and those benefits, unless these cannot reasonably be estimated or it is not reasonably practicable to produce an estimate.
28. The new rules are designed to replace the current supervisory approach under which we work with issuers before new issues are launched. In the future, instead of agreeing minimum denominations that exclude most retail investors from the market, we will have restrictions on the type of retail investor to whom firms may distribute these instruments.
29. If we do not make the proposed rules, we would continue with the current supervisory approach. We do not consider this to be as satisfactory an option. The case-by-case approach lacks transparency and consistency. It also uses significant FCA resources and is not as efficient a use of our resource as a rule-based approach would be. It would also be possible for UK firms to issue instruments in other jurisdictions, avoiding our involvement in shaping prospective issues, then to market those instruments to retail clients via a UK branch network. It would also be possible for overseas banks to seek to promote small-denomination securities to retail investors in the UK.
30. In summary, the proposals on which we are consulting are:
- rules to limit the type of customer to whom firms may distribute CoCos and pooled investments in CoCos
  - rules requiring prescribed risk warnings to ordinary retail investors, who must also self-certify that they will limit their investment to 5% of their net asset, as a condition for promotions or sales of mutual society shares
  - rules requiring firms to conduct the appropriateness test for non-advised sales of mutual society instruments to retail clients even if they are not carrying on MiFID or equivalent third country business
  - rules requiring firms to keep a record of the basis on which the promotion or sale has been made
  - mandating that the firm’s compliance department must check that the promotion or sale complies with the rules. If the compliance department’s confirmation is delegated, the person responsible for compliance function oversight in the firm must review the approval process on at least an annual basis

31. The proposals will only have an impact on firms that sell these instruments to retail consumers. Where firms do not include retail investors in their customer base, they will not need to make any changes to their processes.

## Costs

### Incremental compliance costs

32. Compliance costs are the direct costs firms incur in order to comply with our proposals. As our proposed rule changes relate only to distribution models, there are unlikely to be direct compliance costs for providers unless providers promote their investments directly to retail customers or they need to make changes to literature that makes reference to our existing rules.
33. Overall, we expect the main compliance costs on distributor firms to be in relation to changing distribution processes and in training staff if they wish to distribute CoCos or mutual society shares to retail clients.
34. The following table shows our estimates of the total industry-wide incremental compliance costs.

Incremental costs	One-off costs	Ongoing costs per year
Training	£2.8m to £5.25m	Minimal
Client classification	£600,000 to £1.125m	£250,000 to £1.75m
Compliance confirmation	£50,000 to £200,000	£500,000 to £2m
Appropriateness test	£2m to £4m	£1.8m to £8.8m
Record keeping	Minimal	£100,000 to £500,000
<b>Total</b>	<b>£5.5m to £10.5m</b>	<b>£2.65m to £13.05m</b>

## Training

35. There will be training costs for firms that wish to promote CoCos or mutual society shares to retail investors. To estimate these costs, we refer to work undertaken to support a previous consultation exercise on the introduction of the appropriateness test.<sup>34</sup> The mean estimate for training in a large firm was £78,000 and, for a medium firm, £10,438.<sup>35</sup> Increasing these figures in line with inflation would give a training cost of around £100,000 for a large firm and around £15,000 for a medium firm.<sup>36</sup>

34 LECG, *MiFID Implementation Cost Survey of the UK Investment Industry*, 31 October 2005, [www.fsa.gov.uk/pubs/international/mifid\\_cost\\_survey.pdf](http://www.fsa.gov.uk/pubs/international/mifid_cost_survey.pdf)

35 Medium firms, for this survey, are those with between 100 and 500 employees. Large firms have more than 500 employees.

36 The RPIJ measure of inflation increased by 26.39% between October 2005 and May 2014.

36. Since the training will need to relate to more than just the appropriateness test, we have doubled these costs to estimate the impact on the market. We assume that issuers will be classed as large firms and third party distributors as medium firms.
37. We estimate a one-off industry-wide cost of between £2.8m and £5.25m.
38. After that, we would expect ongoing training costs to fall within existing business as usual training budgets to demonstrate ongoing competence.

### Client classification

39. The client classification process we are proposing works in a manner that is similar to the one introduced for non-mainstream pooled investments in CP12/19.<sup>37</sup> We are using information from the CBA in that consultation, adjusted in line with inflation, to inform our assessment of the costs here.
40. The one-off cost to firms of introducing systems to categorise clients is expected to be £12,500 per firm. With our earlier assumption of between 48 and 90 firms, this leads to a total industry-wide cost of between £600,000 and £1.125m.
41. We estimate the ongoing cost to firms of categorising each customer to be between £24 and £31 per customer.
42. To estimate the number of consumers that may be affected, we have considered how many retail investors may be able to be assessed as high net worth or sophisticated (the main retail client types to whom we expect CoCo and mutual society shares sales to be made) under our proposals.

- High net worth investors

Mintel reports that 3% of their survey respondents had total savings or investments of £250,000 or more.<sup>38</sup> Since this proportion is not net of debt, we are assuming that only 1.5% of adults meet the wealth criterion for classification as high net worth.

A slightly higher proportion of the population, slightly over 2%, meets the pre-tax income criterion to be assessed as high net worth.<sup>39</sup>

Many of the people who meet one criterion will also meet the other, but to account for the people who meet only one, we assume that 2.5% of the UK adult population may be assessed as high net worth under the current criteria. We therefore estimate that there are 1.25m people in the UK who may be assessed as high net worth.<sup>40</sup>

37 Information is drawn from CP12/19, *Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes*, August 2012, FSA, [www.fsa.gov.uk/static/pubs/cp/cp12-19.pdf](http://www.fsa.gov.uk/static/pubs/cp/cp12-19.pdf)

38 Mintel, *Deposit and Saving Accounts – UK*, April 2014

39 HM Revenue and Customs, *Percentile points from 1 to 99 for total income before and after tax*, 31 January 2014, [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/276204/table3-1a.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/276204/table3-1a.pdf)

40 Office of National Statistics, 2011 population census, shows there are approximately 50m people over the age of 18 in the UK, [www.ons.gov.uk/ons/rel/census/2011-census/population-and-household-estimates-for-the-united-kingdom/stb-2011-census--population-estimates-for-the-united-kingdom.html](http://www.ons.gov.uk/ons/rel/census/2011-census/population-and-household-estimates-for-the-united-kingdom/stb-2011-census--population-estimates-for-the-united-kingdom.html)

- Sophisticated investors

There is less quantitative evidence of the number of retail investors in the UK who may be assessed as sophisticated. We also note that some sophisticated investors will also be high net worth.

For the purposes of our analysis, we assume that there are half as many sophisticated but not high net worth investors as there are high net worth investors: 625,000 investors.

- 43.** We therefore estimate that around 2m UK investors may be assessed as high net worth or sophisticated under our proposals.
- 44.** The rules will also apply to distribution by UK firms to non-UK EEA clients. To estimate the likely number of clients involved we have increased the figures by 10%.
- 45.** In practice, we do not expect firms to seek to distribute the investments to all of these clients. Assuming distribution to between 0.5% and 2.5% of these investors each year would result in between 11,000 and 55,000 client categorisation exercises. This would lead to industry-wide costs of between £250,000 and £1.75m.
- 46.** The process to be followed for retail investors who commit not to invest more than 5% of their net investable assets in mutual society shares relies on self-certification and is, therefore, more mechanistic. So long as clients confirm that they have read the prescribed risk warnings and confirm that they will invest no more than 5% of their net investable assets, they may proceed with the investment. We expect only minimal costs for these clients.

### Compliance confirmation

- 47.** As with the client classification exercise, the compliance confirmation requirements are broadly the same as those introduced for non-mainstream pooled investments, so we refer back to previous CBA, updated in line with inflation, to inform the cost estimate.
- 48.** We estimate that it will take four days (of seven hours per day) of the compliance manager's time to develop the compliance confirmation process. Assuming a cost per hour of £41.60 per hour (for a compliance manager in a large firm) or £69 per hour (for a senior compliance manager),<sup>41</sup> leads to an initial cost of between £1,000 and £2,000 per firm. Based on the earlier estimate of the number of firms in the market, this leads to an estimated one-off cost of between £50,000 and £200,000 for the industry as a whole.
- 49.** Thereafter, the compliance manager must review the process each year. To provide a margin for error, we have assumed that this process will take two seven-hour working days to complete. (In practice, particularly in subsequent years where an existing system is reviewed, we expect less time to be needed.) On this basis, we estimate annual costs of between £600 and £1,000 per firm, or between £30,000 and £90,000 for the industry as a whole.
- 50.** Based on the assumption used in the previous section, of between 11,000 and 55,000 client categorisation exercises per annum and assuming a cost per hour of £18 for compliance staff, and two hours per confirmation exercise, we estimate a total industry-wide cost of between £500,000 and £2m for undertaking the confirmation exercise each year.<sup>42</sup>

<sup>41</sup> Standardised hourly rates for management costs are drawn from *Estimation of FSA administrative burdens*, June 2006, Real Assurance Risk Management, [www.fsa.gov.uk/pubs/other/admin\\_burdens\\_report\\_20060621.pdf](http://www.fsa.gov.uk/pubs/other/admin_burdens_report_20060621.pdf)

<sup>42</sup> Hourly costs are again drawn from the *Estimation of FSA administrative burdens*, June 2006.

### Appropriateness test

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51. To assess the incremental compliance cost of introducing the appropriateness test for non-advised sales of mutual society shares (where COBS 10 would not otherwise apply), we have referred again to the work done in preparation for the introduction of MiFID.
52. The industry survey reported the mean estimated cost of setting up systems to be £34,553.<sup>43</sup> Increasing this in line with inflation would suggest the mean cost would now be approximately £45,000. This would result in a total industry-wide one-off cost of between £2m and £4m.
53. The survey suggested the average cost per client of gathering information to conduct the test would be £31 (approximately £40 taking account of inflation since then).
54. As before, we estimate a total of between 11,000 and 55,000 high net worth and sophisticated clients per annum.
55. Regarding ordinary retail investors to whom firms may wish to sell mutual society shares under our proposals, we consider that it is most likely that people with higher amounts of savings who will be interested. These are the clients most likely to be willing to diversify some of their cash holdings. Mintel reports that 16% of their survey respondents had total savings or investments of £50,000 or more.<sup>44</sup> Extrapolating from this, we estimate that 8m people in the UK have savings and investments of £50,000 or more. Taking account of those classified as high net worth or sophisticated leaves 6m people. Again we have increased the number of clients by 10% to account for non-UK EEA retail clients. Assuming distribution to between 0.5% and 2.5% of these clients each year would result in between 33,000 and 165,000 assessments of appropriateness.
56. In total, this would result in an industry-wide annual cost of between £1.8m and £8.8m.

### Record keeping

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57. Firms are already subject to record-keeping requirements in SYSC and COBS 4.11 in relation to marketing. The proposals in this consultation paper will specifically require them to maintain detailed records of the basis on which an investment has been promoted or sold and the confirmation of compliance with the new rules.
58. As firms are already obliged to keep records and will have processes in place for them, we estimate that there will only be minimal one-off costs for changing the record keeping. Some of the one-off costs for developing client classification systems, compliance confirmation processes and for training may involve consideration of record keeping requirements.
59. According to the LECG industry survey from 2005, the average annual cost per client of meeting new record keeping requirements was £1.60 (excluding firms that reported zero additional costs and the high outliers). Increasing these costs in line with inflation, would increase the average cost to £2 per client.

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43 LECG, *MiFID Implementation Cost Survey of the UK Investment Industry*, 31 October 2005, [www.fsa.gov.uk/pubs/international/mifid\\_cost\\_survey.pdf](http://www.fsa.gov.uk/pubs/international/mifid_cost_survey.pdf)

44 Mintel, *Deposit and Saving Accounts – UK*, April 2014

60. As before, we estimate a total of between 11,000 and 55,000 high net worth and sophisticated clients per annum, and between 33,000 and 165,000 ordinary retail investors for mutual society shares. We therefore estimate an incremental cost for record keeping of between £100,000 and £500,000 per annum.

#### **Indirect costs**

61. The main indirect costs expected are as follows.
- New requirements to classify investors prior to distributing the investment will, where the client ultimately decides not to make an investment and unless a fee is charged, be a cost on the firm that is not off-set by remuneration from the ultimate sale.
  - Issuers may need to consider changes to their literature. We expect this cost to be minimal, however, as most consumer-facing communications will be developed by distributors.
  - We recognise that some issuers may face a higher cost of capital if we restrict the distribution of these securities in the retail market. We are not counting this as a cost as we consider that too concentrated an investment in the hands of ordinary retail investors is likely to amount to a market failure, particularly for CoCos.
  - There may be some ordinary retail investors who lose access to suitable investments as a result of these proposals. Instead, their choice will be limited to other investments. We do not expect many customers to be affected by this. Retail investors for whom investment in CoCos may be suitable are highly likely to meet the criteria to be categorised as sophisticated or high net worth and firms will still be able to sell them these investments. Any retail investor will be able to buy mutual society shares if they wish, subject to the safeguards provided by the prescribed risk warnings, an undertaking to invest no more than 5% of the individual's net assets, and the appropriateness test.
  - Were this to reduce the number of investors, there may be a reduction in liquidity for CoCos and/or mutual society shares. We do not regard this as a significant risk, however, as CoCos are primarily institutional market investments (at least in the UK). The largest building societies are also able to raise capital from institutional markets. Unlisted mutual society shares are likely to be fairly illiquid at the best of times, and on the whole we expect the net impact of our proposals on mutual society shares to be to facilitate capital-raising efforts by smaller societies compared to the current position.

### **Benefits**

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#### **Benefits for investors**

62. As noted in the market failure analysis section above, our proposals focus on protecting ordinary retail investors from exposure to securities they are unlikely to be able to understand and evaluate, and who are less likely to be able to cope with the capital losses that may materialise. The main benefit that we anticipate for investors relates to the avoidance of potential capital losses for those consumers for whom the instruments are unlikely to be suitable, in particular consumers of limited means for whom capital losses could cause particularly serious detriment. Note that the capital losses discussed here do not amount to detriment for investors who understand the risks and are willing and able to accept the possible loss of capital; in this situation the loss is a risk that the customer is prepared to take.

## CoCos

63. To provide an estimate of the possible benefits of our approach we have considered a situation in which there is no regulatory restriction on the retail distribution of CoCos, using an issuance size of £1bn. Assuming that 20% of the investment was by retail clients and, of these, 50% were ordinary retail investors, we could assume that around 10% of the issuance was held by ordinary retail investors (£100m).<sup>45</sup> If, on the other hand, retail exposure were to be modest, say of 2%, and ordinary retail investors accounted for half of this, it would mean that £10m was held by ordinary retail investors.
64. In such an event there is also likely to be a contagion effect as the market reacts to the situation. In one survey, for example, it was reported that, on average, investors expect a 9% drop for CoCos across the board on the first deferral of coupons, and a 15% drop in market prices following a triggered conversion.<sup>46</sup> Therefore, ordinary retail investors with inappropriate holdings of similar instruments from different issuers may also face detriment. Using similar assumptions as above, but this time assuming five banks had issued CoCos and one of them converts, we could estimate a total detriment of between £6m and £60m. If, instead, we assume ten banks had issued CoCos and one of them converts, we could estimate a total detriment of between £13.5m and £135m.<sup>47</sup>
65. Based on the above assumptions, we can estimate a total benefit as follows.

	Amount of benefit	
	Assuming 2% retail investment	Assuming 20% retail investment
Benefit to ordinary retail investors who avoid holding a CoCo that converts	£10m	£100m
Benefit to ordinary retail investors who avoid holding other CoCos that lose money through contagion and there are five CoCos in the market	£6m	£60m
Benefit to ordinary retail investors who avoid holding other CoCos that lose money through contagion and there are ten CoCos in the market	£13.5m	£135m
<b>Total assuming five CoCos in the market</b>	<b>£16m</b>	<b>£160m</b>
<b>Total assuming ten CoCos in the market</b>	<b>£23.5m</b>	<b>£235m</b>

66. For every 1% probability that a conversion takes place, therefore, there is between £160,000 and £2.35m of benefit to ordinary retail investors.
67. We also expect there to be benefits for those retail clients for whom the investments may be suitable and to whom firms may distribute them under our proposals. Firms will be able to promote, sell or arrange investment for the clients and, as a result of a wider pool of potential investors, there may be greater liquidity in the market. We note that, as ever, if these investors receive unsuitable investment advice or unfair, unclear or misleading communications about the investments and suffer detriment as a result, they will still be able to seek redress under the usual complaints process.

45 If we assume an average holding of £25,000 per retail investor, the likely number of investors is consistent with the numbers estimated in our cost analysis.

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

47 To calculate these benefits, we assume first five banks, then 10 banks, issue CoCos of £1bn each. The lower estimate assumes 2% of investors are retail clients and the higher estimate assumes 20% of investors are retail clients. Of these, we assume 50% are ordinary retail investors. Figures show the loss incurred if one of these CoCos converts and contagion leads to a 15% price fall for the remaining CoCos.

### Mutual society shares

68. Mutual society share issuance sizes are likely to be smaller than for CoCos but we expect retail investors to account for a greater proportion of investment in them. To estimate the benefits, we consider issuance sizes of £10m and £100m and that retail investors account for between 50% and 75% of investment. Assuming that 50% of these investors are ordinary retail investors, we can assume that, for an issuance size of £10m, between £2.5m and £3.75m is held by ordinary retail investors. For an issuance size of £100m, we can assume that between £25m and £37.5m is held by ordinary investors.
69. Part of the benefit of our proposals derives from the proposed concentration limit, in that ordinary retail investors are warned that investment of more than 5% of their net assets is unlikely to be in their interests and, for non-advised sales which are not MiFID or equivalent third country business, the investor is asked to undertake not to invest more than that in mutual society shares. Should the issuer suffer financial difficulty and the share prices fall, consumers will not be subject to losses that could have a serious impact on their financial circumstances, a particular risk for investors who are neither sophisticated nor wealthy. To calculate the benefit of our proposals, we consider what might happen if there were no regulatory intervention and the proportion invested per customer was between 25% and 50% of the customer's net assets. If the share price fell substantially by, say 50%, our proposals would provide benefit of:
- between £250,000 and £850,000 for an issuance size of £10m
  - between £2.5m and £8.5m for an issuance size of £100m
70. For every 1% possibility of such an event, therefore, there is:
- between £2,500 and £8,500 of benefit to ordinary retail investors for an issuance size of £10m
  - between £25,000 and £85,000 of benefit to ordinary retail investors for an issuance size of £100m
71. We also expect there to be benefits for the retail clients to whom firms may distribute mutual society shares under our proposals. As well as a financial benefit, these clients may derive a non-monetary benefit from being able to support the society's aims through the investment.

### Benefits for issuers

72. The introduction of our proposals should lead to greater certainty for issuers, and more flexibility in setting the terms and minimum denominations of new issues. The ability of firms to distribute these investments to retail clients, subject to the proposed requirements, could broaden the range of investors and possibly increase liquidity in the market.

### Benefits for distributors

73. For distributors we expect the introduction of these rules to provide greater transparency and clarity on our views of these investments and the type of customer to whom we expect them to be distributed in the retail market.

### Benefits for the FCA

74. In the longer term, we expect the need for FCA resource to reduce as our new approach becomes embedded and the market becomes more established, with firms adapting to the new regime and the risks to retail customers receding.

## Conclusion

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**75.** Based on our assumptions on the costs, market growth and possible loss per default, we estimate that:

- if market growth and the share of ordinary retail investment is at the low end of our assumptions, benefits will outweigh costs if, on average, at least £234m of securities experience difficulty or trigger each year
- if market growth and the share of ordinary retail investment is at the high end of our assumptions, benefits will outweigh costs if, on average, at least £65m of securities experience difficulty or trigger each year

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

## Annex 2

# Compatibility statement

1. We are required by section 138I(2)(d) of FSMA to explain why we believe our proposed rules are compatible with our strategic objective, advance one or more of our operational objectives, and have regard to the regulatory principles in section 3B of FSMA. We are also required by section 138K(2) of FSMA to state whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.
2. This annex also sets out our 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 that promotes effective competition in the interests of consumers (section 1B(4) of FSMA). This duty applies in so far as promoting competition is compatible with advancing our consumer protection and/or integrity objectives.

### Compatibility with the our general duties

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3. The proposals in this consultation are designed to advance our objective of securing an appropriate degree of consumer protection by restricting the distribution of certain investments to consumers for whom they are unlikely to be suitable.
4. By aligning the ability of firms to promote these securities to the consumers for whom they are most likely to be suitable, we also believe our approach will promote effective competition in the interests of consumers.

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

5. The restrictions on regulatory capital limit the distribution of largely untested, complex and risky securities to unsophisticated retail clients of ordinary means, who are at the greatest risk of mis-selling these securities, and thereby suffering consequential potential detriment. The use of rules to achieve this is more resource-efficient than the current case-by-case supervisory approach.

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

6. We consider our proposals to be appropriate and proportionate. They protect ordinary retail investors but preserve firms' ability to promote these investments to those investors for whom they are more likely to be appropriate.

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

7. The proposed restrictions on regulatory capital would not stop banks or building societies from issuing instruments to raise capital, but simply align the ability to distribute these securities with the types of consumer most likely to be able to understand the risks or be able to afford capital loss.

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

8. We consider that the proposed rules recognise differences between banks and building societies, between issuers and distributors, and between MiFID and non-MiFID business. On the whole the proposed rules apply the greatest restrictions to transactions in CoCos which are not MiFID or equivalent third country business. In relation to issuers, the proposed rules on CoCos apply only in relation to the original issuance, where issuers have the most control. The proposed rules would still apply to distributors intermediating transactions CoCos in the secondary market. The proposed rules impose requirements on the original issuance of mutual society shares and recognise that smaller building societies in particular may have little or no access to capital markets.

**The responsibilities of senior management**

9. To ensure compliance with the proposed restrictions, we include a focus on senior management responsibility in the requirement for the compliance director of distributor firms to evaluate the process by which compliance confirmation takes place. If we find systematic failures in a firm in the future, we will be able to take enforcement action against senior management, if appropriate.

**The desirability of publishing information relating to persons**

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

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

11. We have been transparent over our intention to intervene. We announced our plan to consult on restrictions for CoCos and mutual society shares in FCA PS13/3, published in June 2013.<sup>48</sup>
12. We announced the introduction of temporary product intervention rules for CoCos on 5 August 2014, ahead of their implementation on 1 October 2014.<sup>49</sup> This allowed firms to prepare for the new requirements.

**The general principle that consumers should take responsibility for their decisions**

13. Consumers can only be expected to take responsibility for their investment decisions where they are in a position to understand the investments offered and the risks to which money will be exposed. We believe ordinary retail investors are likely to struggle with the investments on which we are consulting. High net worth and sophisticated retail investors are better able to make their own judgements on these investments (or to be able to afford specialist advice).

**Expected effect on mutual societies**

14. In performing our regulatory activities, we must consider the impact of new rules on mutual societies. A particular challenge for mutual societies, in relation to capital-raising instruments, is that mutuality precludes raising capital by way of issuing ordinary equity shares, such as those issued by companies. This can lead mutual societies to issue alternative instruments, such as CoCos and CCDS. We are concerned about the risks that these instruments present to ordinary retail investors.
15. We do not consider there to be a need to treat mutual society issuances of CoCos in a different manner to those issued by other institutions. We expect only the largest mutual societies will undertake the complex and expensive exercise of issuing CoCos; such mutual societies have access to institutional investors. We do not expect the restriction on CoCos to have a

<sup>48</sup> *Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes*, FCA, PS13/3, June 2013: [www.fca.org.uk/static/documents/policy-statements/ps13-03.pdf](http://www.fca.org.uk/static/documents/policy-statements/ps13-03.pdf)

<sup>49</sup> *Temporary product intervention rules: Restrictions in relation to the retail distribution of contingent convertible instruments*, August 2014: <http://www.fca.org.uk/static/documents/temporary-product-interventions/restrictions-in-relation-to-the-retail-distribution-of-cocos.pdf>

significantly different impact on issues of CoCos by mutual societies as compared to other types of credit institution. Our rules still allow for distribution to non-retail clients, sophisticated retail clients and high net worth retail clients.

16. The proposed restrictions on other types of mutual society shares, such as CCDS, function in a different way. We are consulting on rules that allow ordinary retail investor participation, subject to compliance with required safeguards.

#### **Legislative and Regulatory Reform Act 2006 (LRR)**

17. We are required under the Legislative and Regulatory Reform Act 2006 (LRR) to have regard to the principles in the LRR and to the Regulators' Compliance Code when determining general policies and principles and giving general guidance (but not when exercising other legislative functions). We consider that our proposal is:

- **Transparent:** We are following a consultation process in making these rules.
- **Accountable:** We are seeking feedback from this consultation paper on whether stakeholders agree with our proposed approach.
- **Proportionate:** We have carefully deliberated on our approach and believe our proposals are proportionate. The proposed rules and guidance should protect ordinary retail investors but allow firms greater flexibility when working with high net worth or sophisticated retail investors for whom the investments are more likely to be appropriate.
- **Consistent:** Our proposed approach applies in a consistent manner to firms distributing the investments covered by this consultation exercise.
- **Targeted only at cases in which action is needed:** As explained in this paper, we consider there to be a strong case for the introduction of these measures.

18. We have also had regard to the Regulators' Compliance Code for the parts of the proposals that consist of general policies, principles or guidance. We consider that the proposals will be effective in helping firms understand and meet regulatory requirements more easily, in a manner that leads to improved outcomes for consumers and addresses the significant risks in this market. We have sought to adopt an approach that avoids stifling economic progress.

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

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19. In making any rule, we ensure that it is compatible with our duty to promote effective competition in the interests of consumers.
20. To exert effective competitive pressure, consumers need to assess quality and price (value) adequately. We see marked information asymmetries for the investments subject to this consultation.
21. Further, behavioural biases are expected to play a significant role, were we not to intervene. The current low interest environment and consumer desire for yield is likely to lead to a focus on headline rates without a sufficient understanding of the nature and risks of the product or a fair assessment of value for money.

- 22.** We do not consider that other solutions on their own, such as additional disclosure, are likely to be sufficiently effective given the need for specialised knowledge, and the unfamiliar and untested nature of these investments. Additional disclosures are, however, a key element of our proposals in relation to the distribution of mutual society shares to ordinary retail investors.
- 23.** For these reasons, we conclude that limiting the retail distribution of the investments is an appropriate way to try to ensure that firms compete to distribute suitable – rather than unsuitable – investments to ordinary retail investors. The investments within scope of this consultation are more likely to be suitable for high net worth and sophisticated investors in the retail market and those consumers are more likely to be able to engage effectively in this market without suffering from information asymmetries to the same extent.
- 24.** By restricting the ability of firms to distribute the investments to the retail consumers for whom they are likely to be unsuitable, we believe the rule will prevent competition becoming focused on unsuitable sales, which would not be in the interests of consumers. We do not expect this to have any significant negative impact on competition whilst delivering significant consumer protection benefits.

## Annex 3

# List of questions

- Q1:** Do you agree with our proposals to restrict the retail distribution of CoCos?
- Q2:** Do you believe the risks of inappropriate distribution identified in this paper apply to other types of CoCo, for example, those that may be issued by credit institutions outside the EEA, or by insurers in the EEA?
- Q3:** Do you agree with our proposal to require records to be kept for each promotion or sale of these instruments to retail clients?
- Q4:** Do you agree with our proposal to require the compliance department to confirm the compliance of each promotion or sale?
- Q5:** Do you agree that the person responsible for compliance function oversight in the firm must review the approval process for compliance confirmation on at least an annual basis?
- Q6:** Do you agree with our proposal to apply the same restrictions to pooled investments in CoCos?
- Q7:** Do you have any comments on the Guidance we propose for the classification of retail clients as sophisticated for the purpose of investment in loss-absorbing regulatory capital?
- Q8:** Do you believe we should subject all mutual society shares to the same distribution restrictions as CoCos or do you consider there is a need to allow the wider retail distribution of mutual society shares?
- Q9:** Alternatively, do you believe applying to CoCos the same approach as proposed for mutual society shares would achieve an appropriate degree of consumer protection?

- Q10:** Do you believe secondary market transactions should be subject to the same rules as primary market sales?
- Q11:** Do you agree with the proposed basis on which mutual society shares could be distributed in the retail market?
- Q12:** Do you agree with our proposal to require firms to conduct an appropriateness test in relation to non-advised sales of mutual society shares to ordinary retail investors even if they are not carrying on MiFID or equivalent third country business?
- Q13:** Do you agree with our proposal to require records to be kept for each sale of mutual society shares to retail clients?
- Q14:** Do you agree with our proposal to require the compliance department to confirm the compliance of each mutual society share sale?
- Q15:** Do you agree that the person responsible for compliance function oversight in the firm must review the approval process for compliance confirmation on at least an annual basis?
- Q16:** Do you have any comments on the impact of our proposals on existing investors?
- Q17:** Do you have any comments on our analysis of the market for CoCos and mutual society shares or further information about it?
- Q18:** Do you have any comments on our cost benefit analysis for the proposals relating to CoCos, pooled investments in CoCos and mutual society shares?

# Appendix 1

## Draft Handbook text

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

### **Powers exercised**

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

### **Commencement**

- C. This instrument comes into force on [1 October 2015].

### **Amendments to the FCA Handbook**

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

### **Citation**

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

By order of the Board of the Financial Conduct Authority  
[date]

## Annex A

### Amendments to the Glossary of definitions

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

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

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

- (a) Additional Tier 1 instruments under article 52; or
- (b) Tier 2 instruments under article 63, if the provisions governing the instrument require that, upon the occurrence of a trigger event, the principal amount of the instrument be written down on a permanent or temporary basis or the instrument be converted to one or more common equity Tier 1 instruments;

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

*mutual society share* a *share* which:

- (a) meets the requirements for common equity Tier 1 capital instruments under article 28 or 29; and
- (b) is issued by an institution which is of a type listed in article 27;

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

## Annex B

### Amendments to the Conduct of Business sourcebook (COBS)

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

#### 9.3 Guidance on assessing suitability

...

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

- 9.3.5 G (1) ~~Firms should note that section 238 of the Act and COBS 4.12.3R set out restrictions on the promotion of non-mainstream pooled investments to retail clients.~~ Firms should note that restrictions and specific requirements apply in relation to the retail distribution of certain investments:
- (a) non-mainstream pooled investments are subject to a restriction on financial promotions (see section 238 of the Act and COBS 4.12);
  - (b) non-readily realisable securities are subject to a restriction in relation to direct offer financial promotions (see COBS 4.7);
  - (c) contingent convertible instruments and CoCo funds are subject to a restriction on financial promotions, dealing, arranging and other distribution-related activities (see COBS 22.2);
  - (d) mutual society shares are subject to specific requirements in relation to dealing and arrangement activities (see COBS 22.3).
- (2) A firm should satisfy itself that an exemption is available before recommending an investment subject to a restriction on distribution to a retail client, noting in particular that a personal recommendation to invest will generally incorporate a financial promotion.
- (2) (a) ~~Firms should bear in mind that the provision of advice or information may involve the communication of a financial promotion (see PERG 8). In particular, making a personal recommendation that a client should enter into a non-mainstream pooled investment will generally amount to a financial promotion of that investment because a personal recommendation typically includes an invitation or~~

inducement to engage in investment activity.

- (b) ~~Due to the restrictions in section 238 of the Act and COBS 4.12.3R, the promotion of a *non-mainstream pooled investment* to a *retail client* is not permitted except where a valid exemption is available and relied on by the *firm* communicating the promotion. *Firms* should therefore first satisfy themselves that an exemption is available in relation to the promotion of the *non-mainstream pooled investment* before recommending the investment to a *retail client*.~~
- (3) (a) In addition to assessing whether the promotion is permitted, a *firm* giving advice on a *non-mainstream pooled investment designated investment* subject to a restriction on distribution should comply with their obligations in COBS 9 and ensure any *personal recommendation* is suitable for its client.
- (b) ~~In considering its obligations under COBS 9, a *firm* purchasing a *non-mainstream pooled investment* on behalf of a *client* as part of a discretionary management agreement should have regard to whether that *client* is a *person* to whom promotion of that *non-mainstream pooled investment* is permissible under COBS 4.12.4R(5). Whilst the restriction in COBS 4.12.3R does not affect transactions where there is no prior communication with the *client* in connection with the transaction, a *discretionary investment manager* should exercise particular care to satisfy himself that the transaction is suitable for the *client* and that it is in that *client's* best interests, if promotion of the investment would not have been permitted.~~
  - (i) In considering its obligations under COBS 9, a *firm* purchasing a *designated investment* subject to a restriction on distribution on behalf of a *retail client* as part of a discretionary management agreement should exercise particular care to ensure the transaction is suitable and that it is in that *client's* best interests, having regard to the *FCA's* view that such *designated investments* pose particular risks of inappropriate distribution.
  - (ii) For example, a restriction on promotion does not affect a transaction where there has been no prior communication with the *client* in connection with the investment by the *firm* or a *person* connected to the *firm*. Nonetheless, if promotion of a *designated investment* to a *retail client* would not have been permitted, then the discretionary manager's decision to purchase it on behalf of the *retail client* should be supported by detailed and robust justification of his

assessment of suitability.

...

In COBS 22 (Restrictions on distribution of contingent convertible instruments) insert the following new sections after COBS 22.1. The text is not underlined.

## **22.2 Restriction on the retail distribution of contingent convertible instruments and CoCo funds**

### Restriction

- 22.2.1 R (1) A *firm* must not sell or do anything else that would or might result in a *retail client* in the *EEA* buying:
- (a) a *contingent convertible instrument*;
  - (b) a *security* issued by a *CoCo fund*; or
  - (c) a beneficial interest in either of (a) or (b).
- (2) The restriction in (1) does not apply if the *firm* has taken reasonable steps to ensure that one (or more) of the exemptions in *COBS 22.2.2R* applies.
- (3) In this section a *retail client* includes a *person* who would be a *retail client* if he were receiving services from the *firm* in the course of the *firm* carrying on a *regulated activity*.

### Exemptions

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

<b>Title</b>	<b>Type of retail client</b>	<b>Additional conditions</b>
Certified high net worth investor	<ul style="list-style-type: none"><li>(a) An individual who meets the requirements set out in <i>COBS 4.12.6R</i>; or</li><li>(b) an individual in an <i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.6R</i>; or</li><li>(c) a <i>person</i> (or <i>persons</i>)</li></ul>	The <i>firm</i> must consider that the <i>contingent convertible instrument</i> or <i>CoCo fund</i> is likely to be suitable for that individual, based on a preliminary assessment of that individual's profile and objectives. [See <i>COBS 4.12.5G(2)</i> .]

	legally empowered to make investment decisions on behalf of an individual who meets the earnings or net asset requirements in (a) or (b) above.	
Certified sophisticated investor	<p>(a) An individual who meets the requirements set out in <i>COBS 4.12.7R</i>; or</p> <p>(b) an individual in an <i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.7R</i>; or</p> <p>(c) an individual who meets the requirements for either (a) or (b) above and who is legally empowered (solely or jointly with others) to make investment decisions on behalf of another person who is the <i>firm's client</i>.</p>	Not applicable.
Self-certified sophisticated investor	<p>(a) An individual who meets the requirements set out in <i>COBS 4.12.8R</i>; or</p> <p>(b) an individual in an <i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.8R</i>; or</p> <p>(c) an individual who meets the requirements for either (a) or (b) above and who is legally empowered (solely or</p>	<p>The <i>firm</i> must consider that the <i>contingent convertible instrument</i> or <i>CoCo fund</i> is likely to be suitable for that individual, based on a preliminary assessment of that individual's profile and objectives. [See <i>COBS 4.12.5G(2)</i>.]</p>

	jointly with others) to make investment decisions on behalf of another <i>person</i> who is the <i>firm's client</i> .	
Solicited advice	Any <i>retail client</i> .	The restriction does not apply provided all of the following requirements are met: (a) there is no <i>financial promotion</i> other than a <i>personal recommendation</i> on the <i>contingent convertible instrument</i> or <i>CoCo fund</i> ; (b) the <i>personal recommendation</i> is made following a specific request by that <i>client</i> for advice on the merits of investing in the <i>contingent convertible instrument</i> or <i>CoCo fund</i> ; and (c) the <i>client</i> has not previously received a <i>financial promotion</i> or any other communication from the <i>firm</i> (or from a <i>person</i> connected to the <i>firm</i> ) which is intended to influence the <i>client</i> in relation to investment in <i>contingent convertible instruments</i> or <i>CoCo funds</i> . [See Note 1.]
<i>MiFID</i> or equivalent <i>third country business</i> other than <i>financial promotions</i>	Any <i>retail client</i> .	If the prohibited activities in COBS 22.2.1R amount to <i>MiFID</i> or equivalent <i>third country business</i> , that rule only applies to the extent that the prohibited activity is the <i>communication</i> or <i>approval</i> of a <i>financial promotion</i> .
Prospectus	Any <i>retail client</i> .	The restriction does not apply to the distribution of a prospectus required under the <i>Prospectus Directive</i> .
Issuers	Any <i>retail client</i>	To the extent that the <i>firm</i> is acting as issuer of a <i>contingent</i>

		<i>convertible instrument</i> , the restriction only applies to the original issuance of the <i>contingent convertible instrument</i> and not to subsequent trading in the secondary market.
Clearing, custodial and processing services	Any <i>retail client</i>	The restriction does not apply to the extent that the <i>firm's</i> activities relate to clearing, registration or settlement of transactions in <i>contingent convertible instruments</i> or <i>CoCo funds</i> (or rights to or interests in such instruments), any back office processing or reporting of such transactions, or custody of <i>contingent convertible instruments</i> .
Indirect investment	Any <i>retail client</i>	The restriction does not apply in relation to a beneficial interest in a <i>contingent convertible instrument</i> acquired through participation in a <i>regulated collective investment scheme</i> , investment in a <i>non-mainstream pooled investment</i> (provided it is not a <i>CoCo fund</i> ), or membership of an <i>occupational pension scheme</i> .
Note 1	A <i>person</i> is connected with a <i>firm</i> if it acts as an <i>introducer</i> or <i>appointed representative</i> for that <i>firm</i> or, if it is any other <i>person</i> , regardless of <i>authorisation</i> status, who has a relevant business relationship with the <i>firm</i> .	
Note 2	See <i>COBS 2.4</i> for rules and guidance on agent as <i>client</i> and reliance on others.	

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

- 22.2.3 R (1) For the purposes of compliance with this section and with any assessments or certifications required by the exemptions set out in *COBS 22.2.2R*, any references in *COBS 4.12* provisions to *non-mainstream pooled investments* must be read as though they are references to *contingent convertible instruments* or *CoCo funds*, as

relevant.

- (2) If the *firm* is relying on the high net worth investor exemption, the sophisticated investor exemption or the self-certified sophisticated investor exemption for the purposes of compliance with this section, the statement the investor must sign should have references to *non-mainstream pooled investments* replaced with references to *contingent convertible instruments* or *CoCo funds*, as relevant.
- (3) The *firm* must give the *retail client* a written copy of any statements that individual has been asked to sign as part of certification as a high net worth, sophisticated or self-certified sophisticated investor for the purposes of compliance with this section.

22.2.4 G A *firm* wishing to certify a *retail client* as a sophisticated investor for the purposes of this section should note that, in the *FCA*'s view, it is likely that the only *retail clients* with the requisite sophistication in relation to *contingent convertible instruments* or *CoCo funds* are those with extensive experience in multiple types of complex *financial instruments* and who have sufficiently in-depth understanding of how *credit institutions* are run, including any risks arising from different business models to the ongoing meeting of those institutions' prudential requirements.

#### Record keeping

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

- 22.2.6 G To the extent the requirements set out in *COBS 22.2.5R* apply to the *communication or approval* of any invitation or inducement, such requirements are in addition to those set out in *COBS 4.11*.

### 22.3 Requirements on the retail distribution of mutual society shares

#### Application

- 22.3.1 R (1) The requirements set out in this section apply to a *firm* when *dealing* in or *arranging a deal* in a *mutual society share* with or for a *retail client* in the *EEA* where the *retail client* is to enter into the deal as buyer.
- (2) The requirements in this section do not apply if:
- (a) the *firm* has taken reasonable steps to ensure that one (or more) of the exemptions in *COBS 22.3.4R* applies; or
  - (b) the deal relates to trading of a *mutual society share* in the secondary market.
- (3) In this section a *retail client* of the *firm* includes a *person* who would be a *retail client* if he were receiving services in the course of the *firm* carrying on a *regulated activity*.

#### Risk warning requirement

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

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

- (a) the entire amount you invest is at risk;
- (b) income, distribution or dividend payments are not guaranteed, are entirely discretionary, and may be suspended or cancelled at any time, for any reason;
- (c) the share is a perpetual instrument and has no maturity date, and there is no obligation on the issuer to buy the share back;
- (d) the share may be difficult to sell on for the price you paid for it, or any price; and

- (e) investing more than 5% of your savings or net investment portfolio in this type of instrument is unlikely to be in your best interests.”

Further requirements for non-advised, non-MiFID sales

- 22.3.3 R (1) If:
- (a) the *firm* is not providing an *investment service* in the course of *MiFID* or *equivalent third country business*; and
  - (b) the *retail client* is not otherwise receiving *advice* on the *mutual society share* from the *firm* or another *person*;

the further requirements in (2) and (3) must also be met.

- (2) The *firm* must give the *retail client* the following statement on paper or another *durable medium* and obtain confirmation in writing from the *retail client* that he has signed it, in good time before the *retail client* has committed to *buy the mutual society share*:

“I make this statement in connection with proposed investment in mutual society shares. I have been made aware that investing more than 5% of my net assets in mutual society shares is unlikely to be in my best interests. I declare that the proposed investment would not result in more than 5% of my net assets being invested in mutual society shares. Net assets for these purposes mean my financial assets after deduction of any debts I have, and do not include:

- (a) the property which is my primary residence or any money raised through a loan secured on that property;
- (b) any rights of mine under a qualifying contract of insurance (for example, a life assurance or critical illness policy); or
- (c) any benefits (in the form of pensions or otherwise) which are payable on the termination of my service or on my death or retirement and to which I am (or my dependants are) or may be entitled.

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

Signature:

Date: ”

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

Exemptions

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

Title	Type of retail client	Additional conditions
Certified high net worth investor	<ul style="list-style-type: none"> <li>(a) An individual who meets the requirements set out in <i>COBS 4.12.6R</i>; or</li> <li>(b) an individual in an <i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.6R</i>; or</li> <li>(c) a <i>person</i> (or <i>persons</i>) legally empowered to make investment decisions on behalf of an individual who meets the earnings or net asset requirements in (a) or (b) above.</li> </ul>	<p>The <i>firm</i> must consider that the <i>mutual society share</i> is likely to be suitable for that individual, based on a preliminary assessment of that individual's profile and objectives.  [See <i>COBS 4.12.5G(2)</i>]</p>
Certified sophisticated investor	<ul style="list-style-type: none"> <li>(a) An individual who meets the requirements set out in <i>COBS 4.12.7R</i>; or</li> <li>(b) an individual in an <i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.7R</i>; or</li> <li>(c) an individual who meets the requirements for either (a) or (b) above and who is legally empowered (solely or jointly with others) to make investment decisions on behalf of another person who is the <i>firm's client</i>.</li> </ul>	Not applicable.

Self-certified sophisticated investor	<p>(a) An individual who meets the requirements set out in <i>COBS 4.12.8R</i>; or</p> <p>(b) an individual in an <i>EEA State</i> other than the <i>UK</i> who meets requirements which are broadly equivalent to those set out in <i>COBS 4.12.8R</i>; or</p> <p>(c) an individual who meets the requirements for either (a) or (b) above and who is legally empowered (solely or jointly with others) to make investment decisions on behalf of another <i>person</i> who is the <i>firm's client</i>.</p>	Not applicable.
Note 1	<p>A <i>person</i> is connected with a <i>firm</i> if it acts as an <i>introducer</i> or <i>appointed representative</i> for that <i>firm</i> or, if it is any other <i>person</i>, regardless of <i>authorisation</i> status, who has a relevant business relationship with the <i>firm</i>.</p>	
Note 2	<p>See <i>COBS 2.4</i> for rules and guidance on agent as <i>client</i> and reliance on others.</p>	

Adaptation of other rules and guidance to mutual society shares

- 22.3.5 R (1) For the purposes of compliance with this section and with any assessments or certifications required by the exemptions set out in *COBS 22.3.4R*, any references in *COBS 4.12* provisions to *non-mainstream pooled investments* must be read as though they are references to *mutual society shares*.
- (2) If the *firm* is relying on the certified high net worth investor exemption, the certified sophisticated investor exemption or the self-certified sophisticated investor exemption for the purposes of compliance with this section, the statement the investor must sign should have references to *non-mainstream pooled investments* replaced with references to *mutual society shares*.
- (3) The *firm* must give the *retail client* a written copy of any risk warning or statement that individual has been asked to sign for the purposes of compliance with this section.

## Record keeping

- 22.3.6 R A *firm* which carries on an activity which is subject to this section must comply with the following record-keeping requirements:
- (1) the *person* allocated the *compliance oversight function* in the *firm* must make a record at or near the time of the activity certifying it complies with the restriction set out in this section;
  - (2) the making of the record required in (1) may be delegated to one or more *employees* of the *firm* who report to and are supervised by the *person* allocated the *compliance oversight function*, provided the process for certification of compliance has been reviewed and approved by the *person* allocated the *compliance oversight function* no more than 12 months before the date of the sale, invitation or inducement;
  - (3) the record required in (1) must include information and evidence demonstrating compliance with each of the requirements in this section, as applicable;
  - (4) if the requirements in *COBS 22.3.2R* and *COBS 22.3.3R* did not apply because the *firm* relied on one of the exemptions, the record required in (1) must include which exemption was relied on, together with the reason why the *firm* is satisfied that that exemption applies;
  - (5) where the *firm* relies on the certified high net worth investor, the certified sophisticated investor or the self-certified sophisticated investor exemption, the record required in (1) must include a copy of the certificate or investor statement (as signed by the investor) and of the warnings or indications required by the exemption.



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