

JOINT ASSOCIATIONS COMMITTEE (JAC) RESPONSE TO THE FSA'S QUARTERLY CONSULTATION (NO. 20) (CP 09/12)

EXECUTIVE SUMMARY

The Joint Associations Committee on Retail Structured Products ("JAC"¹) is pleased to be able to respond to Chapter 7 of the FSA's Quarterly Consultation (No. 20) (CP 09/12) on a proposed new chapter to the Perimeter Guidance manual on packaged structured investment bonds (the "Consultation"). Details of the trade associations represented by the JAC are set out in the Appendix.

In general terms, the JAC support the introduction of guidance on the elements the FSA will consider when assessing whether a packaged structured investment bond is a collective investment scheme ("CIS"). However, certain areas of the guidance need amendment to avoid creating market uncertainty, to capture the breadth of structured products sold via investment plans and to reflect the statutory test for what constitutes a CIS correctly. It is particularly important that the guidance does not confuse conduct of business policy with legal definitional questions as to what constitutes a CIS.

BACKGROUND

The retail structured products market in the United Kingdom is substantial. A large number of structured products are distributed by distributors through investment plans. An investment plan is an arrangement between a distributor and clients of the distributor whereby structured products manufactured by a product provider are marketed and sold to retail clients. An investment plan typically involves the distributor acquiring the products underlying the investment plan on behalf of the client and the client then agreeing to pay over monies to fund the acquisition of those products.

Structured products distributed via investment plans include debt securities (including securitised derivatives), shares in closed end funds, and deposits.

We are aware that the FSA recently threatened enforcement action against one distributor of an investment plan selling structured products on grounds that the distributor was operating an unregulated CIS. This cast doubt on the status of investment plans. This doubt raised concerns for a number of market participants, from product providers and distributors to the investors in the investment plans, as a change in the status of investment plans would have significant adverse tax and regulatory consequences.

We therefore welcome the recognition that guidance on this issue would be helpful.

COMMENTS

Scope

The draft Perimeter Guidance, as set out in Annex 7 of the Consultation, is entitled "Guidance on Packaged Structured Investment Bonds". We feel this may be limiting the usefulness of the guidance, as the same guidance should apply to investment plans which have shares or deposits as their underlying investment, as well as those that have debt securities. Additionally, widening the scope of the guidance, would also be consistent in the context of the broader review of retail investment products by the FSA and the European Commission (as highlighted, for example, by the FSA's Retail Distribution Review launched in June 2006 and the Commission's Communication on Packaged Retail Investment Products dated April 2009). Subject

¹ For information on the sponsoring associations (ICMA, ISDA, LIBA and SIFMA) see Appendix. To discuss the issues raised in this submission, please contact Richard Metcalfe at ISDA (rmetcalfe@isda.org)

to our comments below, the guidance could therefore helpfully be widened to refer to packaged structured investment products throughout.

The legal question of whether an investment plan is a CIS

When considering a CIS it is a legal question as to whether a given structure is a CIS or not. We understand that there may be policy issues for the FSA in assessing the regulatory implications of the use of investment plan structures: we would be delighted to discuss these further. However, these considerations must not influence the question of legal characterisation of investment plans. In particular, the Guidance, as proposed, appears to seek to impose disclosure obligations as a condition of non-CIS status, which is incorrect as a matter of law and arguably an inappropriate use of guidance. To the extent that the FSA considers the use of investment plans gives rise to policy issues around disclosure, there should be a separate debate (outside the question of CIS characterisation) dealing with FSA disclosure requirements. In determining the status of an investment plan the FSA must focus purely on whether the plan meets the statutory criteria for a CIS.

If the Guidance does not accurately reflect the law, this may have serious repercussions – both for investors in plans and for providers and distributors – in the event the courts follow the Guidance (the *Watersheds* case² earlier this year provides a good example of the unintended consequences of poor guidance on legislative interpretation). In particular, characterisation as a CIS would adversely change the tax treatment of many products sold via investment plans (such as ISAs, for example) and could presumably lead to regulatory and legal sanctions for distributors who have sold securities via investment plans. Misleading guidance could also influence firms' willingness to offer securities through investment plans.

FSA therefore should not confuse policy issues with legal criteria for CIS status in the Guidance.

Comments on drafting

We have the following comments on the draft guidance itself.

- (a) *Title*: we would suggest amending the title of the chapter in the Perimeter Guidance to read "Guidance on Packaged Structured Investment Products" rather than "Guidance on Packaged Structured Investment Bonds". We propose this on the basis that some investment plans have shares or (occasionally) deposits, rather than debt securities as their underlying investments. Consequential amendments also need to be made throughout (e.g. Q.3, where the defined term of a "bond" is introduced).
- (b) Q.5: the following points are of concern:
 - (i) in the second bullet point the words "management of the" should be inserted before "underlying investments", consistent with section 235 (2) of the FSMA; and
 - (ii) whether or not the operator of a scheme retains on-going responsibility in relation to the investments is irrelevant in the context of establishing a CIS, i.e. it is not a characteristic prescribed by section 235 of the FSMA (or any exemptions). The fourth bullet point is therefore misleading and should be deleted.
- (c) Q.6: the following points are of concern:
 - (i) in relation to the first bullet point "management control" should read "control of management";
 - (ii) the second bullet point states that the only additional rights of investors should be "limited to any safeguarding and administering of the underlying investments" and

² *Watersheds Ltd v (1) David Da Costa (2) Paul Gentleman* [2009] All ER (D) 140 (Feb)

limits the types of services that the plan manager is entitled to offer. However, in practice, plan managers often offer other services, including liquidity and brokerage on sale. None of these justify recharacterisation of the scheme as a CIS. We do not believe that limiting the availability of such additional services or the enforcement of corresponding rights is relevant or justified and consequently the Guidance should allow for such ancillary arrangements to be offered. This would best be corrected by addition of "of ownership" after "additional rights". A corresponding change needs to be made to the fifth bullet point (add "ownership" before "rights");

- (iii) in addition, plan managers may undertake, as well as arrange, custody. Again, this does not affect the CIS analysis of itself. The words "or undertake" should therefore be added after "arrange"; a corresponding change is needed to the fourth bullet point (insert "or undertake" after "arrange for");
 - (iv) it is misleading to suggest there are any consequences specifically as a result of the packager "retaining discretion" as regards management of the underlying investments. The relevant characteristic of a collective investment scheme is "day-to-day control" and the two concepts are not interchangeable. A number of investment plans grant a measure of discretion to the packager, in connection with the initial selection of the underlying; and
 - (v) the final paragraph states that "if both the underlying bond and the issuer are identified to the investor at or before the time of sale that may point away from the arrangements being a collective investment scheme". This is entirely irrelevant to characterisation as a CIS and is unhelpful in that (as acknowledged) plan managers quite frequently do not provide this level of disclosure. Irrespective of any policy issues thrown up by non-disclosure, the CIS definition is **not** the right tool to seek to regulate disclosure in this way.
- (d) Q.7: whilst it is important to clarify the manner in which investments are held, there should be no suggestion that the outcome of such an analysis is determinative in assessing the characterisation of the plan, particularly given that the analysis regarding proprietary holdings is complex. The Guidance regarding allocation of underlying investments to particular investors is also unhelpful, given the market prevalent use of omnibus accounts in relation to client holdings, and should be deleted.
 - (e) Q.8: we would suggest inserting the following as a final sentence to Q.8: "Accordingly, investors should have an unfettered right to sell the investments free of any obligation to receive the services of the packager" after the penultimate sentence.
 - (f) Q.9: please additionally clarify that the Guidance applies equally where securities are held via a sub-custodian, as well as generally in clearing systems, without affecting the status of the scheme. This would go to addressing specific industry concerns as to the effect of intermediated securities holdings on CIS characterisation.
 - (g) Q.13: we do not agree that the availability of the exemption is in question where the packager controls the account into which the investor's funds are received (although it may be an issue in determining whether the basic requirements for a CIS are established). Nor do we agree with the assertion that a direct contractual relationship is necessary in connection with deposit-taking.
 - (h) Q.15: the words "investments which are" should be inserted between "represented by" and "certain debt securities".

APPENDIX - THE RESPONDENT ASSOCIATIONS

ISDA

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 830 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, ISDA has pioneered the identification and reduction of risk in the derivatives and risk management business. www.isda.org



SIFMA Europe is the European arm of a non-profit industry association that represents the shared interests of participants in the global financial markets. SIFMA members include international securities firms, U.S.-registered broker-dealers, and asset managers. Member participation is the very core of who we are and the key to our effectiveness. SIFMA represents the industry worldwide on regulatory and legislative issues and initiatives, and also serves as a forum for outreach, training, education, and community involvement.



ICMA is a unique self regulatory organisation and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers amongst its 400 member firms. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years, providing the self regulatory framework of rules governing market practice which have facilitated the orderly functioning and impressive growth of the market. ICMA actively promotes the efficiency and cost effectiveness of the capital markets by bringing together market participants, including regulatory authorities and governments.

LIBA

The London Investment Banking Association (LIBA) is the principal trade association in the United Kingdom for firms active in the investment banking and securities industry. The Association represents the interests of its Members on all aspects of their business and promotes their views to the authorities in the United Kingdom, the European Union and elsewhere. For more information, please visit www.liba.org.uk