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Promotion of bonds following the temporary intervention on the marketing of speculative mini-bonds to retail investors published by the Financial Conduct Authority on 26 November 2019

Background

Following our initial response to the FCA's temporary intervention announced on 26 November 2019 (see our update on 26 November entitled 'FCA Update: Temporary Measures Regarding the Issuance of Unlisted Bonds and Shares'), we have the further considered the ramifications of the recent announcement which restricts the financial promotion of 'speculative illiquid securities' to retail investors with effect from 1 January 2020.

The definition of speculative illiquid security is as follows:

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

We have advised numerous bond issuers on structures where the proceeds of a bond issue are to be used for the provision of loans to persons outside of the issuer's group and may also fund the acquisition of an interest in property and/or paying for the construction of property; such bond issues will most likely fall within the definition set out above. In those cases, communications will now only be possible to (1) certified sophisticated investors and (2) certified high net worth investors and/or self-certified sophisticated investors following a modified suitability test. What adjustments must be made to how and to whom the securities are to be marketed, in order to comply with the new rules? Certain immediate steps will be required to update the promotional materials, as set out below.

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Amendments to the promotional material

The new rules require additional risk warnings to be added to any financial promotion of speculative illiquid security and that the date on which any financial promotion that is approved by an FCA authorised person be specified.

In the case of promotions that are not for ISA qualifying securities, the following risk warnings will be required:

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

In the case of any financial promotions relating to bonds that are intended to be ISA qualifying, the following risk warnings and disclosures are required.

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

We suggest you include the new warnings on the inside front cover of any financial promotion, including both any issued Information Memorandum and promotional brochure.

The FCA have stipulated that the relevant risk warnings must be: (1) prominent; (2) contained within its own border and with bold text as indicated; (3) if provided on a website or via a mobile application, statically fixed and visible at the top of the screen even when the retail client scrolls up or down the webpage; and (4) if provided on a website, included on each linked webpage on the website.

It will now also be necessary to include a statement, expressed as both a percentage and a cash sum, the total amount of the capital raised which will be paid out in costs, fees, charges and commissions and any other expenses to any third party. This should follow the form set out above (i.e. prominent and contained within its own border and with bold text). In terms of placement, this must immediately follow the most prominent reference to expected returns, so we would advise that this is included at the front end of any financial promotion document and again next to any returns table (notably in any final terms that are published).

Our first drafts of these boxes are as follows:

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The total amount of the capital raised by the issue of Bonds which will be paid out in costs, fees, charges and commissions and other expenses to any third party, expressed as a percentage of the capital raised is [x]% that is, for every £100 you invest, £[x] will be paid to third parties to meet costs, fees, charges and commissions.

Where appropriate, the following can be inserted:

Accordingly, no actual expenditure that is certain to be paid will be paid out of an investor's capital to any person.

All operational costs will be charged to profits (that is the interest margin between interest paid by Borrowers and interest payable to Bondholders) but, if profits are insufficient, the Company may potentially charge operational costs to cover the day-to-day operations of the Group, from the capital subscribed by Bondholders, but not exceeding an amount equal to 2% per annum of the weighted average of the total capital amount subscribed for Bonds which remains outstanding during any financial period of the Company. The recipients of any such capital payments are likely to be [*Insert name of arranger of the structure*] and its Associates.

We also suggest included a fourth box where such a mechanism has been adopted – this is neither a risk warning nor a disclosure that is required but it is relevant to the issue of costs disclosure and, we think, softens the blow of the risk warning in the first box, which is appropriate given the nature of the retained profit reserve.

No interest income profits will be distributed to shareholders of the Company until a reserve has been created which, when added to shareholder capital, is equal to 5% of the outstanding bond capital; plus accrued but unpaid interest due to bond holders; plus any provision for non-repayment of loans by Borrowers.

This reserve constitutes the Retained Profits Reserve. Any losses in the loan portfolio will be mitigated in part or in full from the Retained Profits Reserve so that, in any accounting period, investors in Bonds will receive the interest and any capital repayments due and payable on their Bond investment(s) in priority to any distributions that may be paid to shareholders.

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Accordingly, any information memorandum and promotional materials will need to updated, along with the websites that have been created to provide detail to investors in respect of the offerings.

Proposed responses

We understand that the new changes will restrict the approach that bond issuers take to marketing their products. We believe there are a number of changes that can be made to offer structures in response to the FCA temporary intervention, which can be summarised as follows:

1. the addition of gateways to your website so that retail investors will only be permitted to view materials that may be construed as financial promotions once modified suitability and appropriateness has been assessed;
2. change the offering so that a separate division within the FCA authorised arranger offers a discretionary fund management service;
3. seek a listing of the bonds and or the loan notes; and
4. seek to fall within the carve outs in respect of the commercial use of property or single UK properties.

We have considered each one on turn below.

1. *Website gateways*

It will be necessary to remove the option for "restricted/everyday" investors to sign up as this isn't an exempt category under the new temporary rules. As we mentioned in our initial response on 26 November (see point two under the section 'So what is new?'), a preliminary assessment of suitability of the clien, requiring the firm to take reasonable steps to acquaint itself with the client's profile and objectives to ascertain whether the bonds and/or loan notes are suitable is required. This should take place before a potential investor is able to access any website promoting the relevant bonds in question. We envisage that the following boxes should pop up before a user can access the websites:

- a confirmation as to the status of the potential investor, with information on each; and
- a suitability test in the case of high net worth and self-certified sophisticated investors, which should cover at least the following areas in respect of the potential investor:
    - their liquidity requirements;
    - their long term investment strategy; and

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- a confirmation that they wish to proceed with the acquisition of a speculative debt instrument.

2. *Discretionary fund management service*

This is an approach currently used by a leading fund manager which we think could be combined with an 'agent as client' approach under COBS 2.4.3, an approach which another leading fund manager adopt in relation to their BPR qualifying product. Under this option, an authorised person would offer a spread of returns with different investment maturity, interest rates and level of risk. It would then engage with IFAs, who would instruct a discretionary fund management arm of the authorised person to select a portfolio of bonds that match the investor's profile and investment ambitions. Under the new temporary rules being introduced by the FCA, this would allow an authorised person to market its offering to retail investors, but as a discretionary fund management service to be taken up by their IFAs as professional clients rather than the investors becoming clients. This would keep the responsibility for undertaking suitability tests with the IFA.

3. *Listing*

The temporary FCA rules include a specific exemption from the definition of speculative illiquid securities where the securities are readily realisable. This includes securities that they are admitted to official listing on an exchange in an EEA State.

We have recent experience of seeking approval for the listing of a £100m bond on the Global Exchange Market of Euronext in Dublin. Taking this approach would come with a degree of additional reporting and disclosure obligations but would allow a bond issuer to market its bonds to the retail sector without the restrictions imposed by the temporary rules. It would also allow a bond issuer to cultivate connections with IFAs who will only propose investments in listed products.

As a broad guideline, we would estimate that a period of up to three months should be allowed to complete a listing application. Our recommendation would be a listing in Dublin, as they apply a relatively light touch application and disclosure regime and, in our experience, are prepared to take a pragmatic approach to applying their rules. They are also of course situated within the EEA and they are unlikely to be impacted by the outcome of Brexit. The most significant strand of work involved will be to update the bond instrument and information memorandum to be fully compliant with the applicable listing rules.

4. *Other Exemptions*

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The FCA has identified two further exemptions from the definition of speculative illiquid securities:

(a) Unlisted debt securities or preference shares issued by companies to purchase property or pay for the construction of property where the relevant property will be used by the company (or a group company) for a 'general commercial or industrial purpose' (the "**Commercial Purpose Exemption**"); and

(b) products involving a single UK property or properties within a single development in the UK ("**Single Property Exemption**").

(a) Commercial Purpose Exemption

To fall within this exemption, the issuer company must be a company that 'uses' the property that it funds for a commercial purpose which it, or a member of its group carries on. 'General commercial or industrial purposes' is defined in wide terms (and includes the supply of services) but does however exclude property development and the provision of construction services.

There is a caveat where an issuers' ability to pay interest or repay capital to investors is dependent or heavily contingent on the return generated from the purchase or construction of the property (which the FCA guidance refers to as speculative property investments). The implications of this for a bond issuing structure is that a sufficient part of any underlying business would need to be transferred to the issuer company (or a member of its group), so that new acquisitions that were being funded by the bonds would not impact on repayment of the securities. It follows that setting up an SPV company would not fall within the exemption.

(b) The Single Property Exemption

Property holding vehicles are exempt from the new rules, although there are a number of conditions attached, which severely restrict its scope. The conditions are that the company: (1) is the legal or beneficial owner of an income generating property (the meaning of which is explained further below); (2) issues debentures which have a fixed maturity date; (3) issues debentures in a sum which does not exceed the value of the income generating property owned; (4) issues only one tranche of debentures; (5) is only engaged with the holding of income generating property and associated activities including the collection of rent or other income from the income generating property and appointing a manager to maintain the

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income generating property; and (6) does not enter into any loan agreement whether as the borrower or lender.

In the context of a bond issuer structure, it could be possible for a number of SPVs to each hold a single property and issue loan notes, although the restriction on loan financing at (6) above means that all other funding would probably need to be through equity investment. The property would also need to be income-generating, and the issuer's activities are limited under the rules so as to preclude property development activities.

The income generating property definition is also worth considering. This includes a requirement that the property is located in the UK and also that the property "is available for occupancy or occupied by persons who have no relationship with the directors of the property holding vehicle and who pay rent at a commercial rate". This is likely to be problematic for bond issuers that on-lend the proceeds to a third party – the intention is that the property will be owned and then leased to a third party.

Conclusion

Please do not hesitate to speak to either me, Roger Blears, Frank Daly or Adam Lawrence as regards any queries arising from the above. We would be delighted to advise.

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