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14 November 2012

Dear Mr Pope

**FSA Consultation Paper CP12/19 (the “Consultation Paper”) on restrictions on the retail distribution of unregulated collective investment schemes (“UCIS”) and close substitutes**

The Joint Associations Committee on Retail Structured Products (the “JAC”)<sup>1</sup> welcomes the opportunity to comment on the proposals set out in the Consultation Paper. Section 1 sets out our general comments on the Consultation Paper, including a number of key points which we believe the FSA should consider when finalising its proposals. Section 2 then sets out our response to the specific questions asked in the Consultation Paper.

**1 General Comments**

- 1.1 The stated aim of the proposed rule changes is ‘to improve retail consumer outcomes by limiting the promotion of UCIS and close substitutes and ensuring that they are recognised as specialised products unsuitable for general promotion in the UK retail market’<sup>2</sup>. This has been prompted by a number of products that were unsuitable for sale to ordinary retail investors having been sold to such investors. The JAC agrees with the stated aims however, in the view of the JAC, the FSA’s proposed rule changes go further than is necessary to achieve these aims and there is a danger that retail consumers may potentially suffer as a result.
- 1.2 As a general observation we would note that the existing CIS legislation provides a statutory regime for the regulation of collective investment products. The definition of collective investment scheme (“CIS”)<sup>3</sup> is deliberately broad in scope and is subject only to certain limited exemptions. The FSA has set out in the Consultation Paper some specific examples of products which have been inappropriately sold to retail investors<sup>4</sup>. The JAC would suggest that many of these products should in any event have fallen within this existing CIS regime and its restrictions on promotions. It is suggested that problems arising from the application of the CIS regime and the CIS definition in practice are best resolved through making the current regime more widely understood. We would also note that the courts are the ultimate arbiters of whether a product is or is not a CIS. Introducing an

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<sup>1</sup> The JAC is sponsored by multiple associations with an interest in structured products. In the first instance, any queries may be addressed to [AJacobs@isda.org](mailto:AJacobs@isda.org)

<sup>2</sup> Paragraph 1.09 of the Consultation Paper.

<sup>3</sup> Section 235 of the Financial Services and Markets Act 2000 (“FSMA”)

<sup>4</sup> Paragraph 30 of Annex 1 of the Consultation Paper.

additional regime would appear to be a disproportionate response and one that introduces an additional and unnecessary level of complexity.

In addition, given that most of the instances highlighted by the FSA relate to a failure by distributors to properly understand and apply the rules<sup>5</sup>, the JAC would suggest that rather than introduce a new concept of ‘non mainstream pooled investments’, a more proportionate means of improving retail consumer outcomes with respect to unsuitable products would be to instead focus on the actions of distributors. In that regard, the FSA has already undertaken significant changes through its Retail Distribution Review (“**RDR**”). In addition to this, the FSA has set out in the Consultation Paper proposals to strengthen the existing financial promotion rules. The JAC agrees with these proposals but would suggest that they, together with the RDR and the guidance given by the FSA to structured product providers through its Retail Product Development and Governance – Structured Product Review, should be sufficient to achieve the Consultation Paper’s stated aims and that an additional definition of non-mainstream pooled investments is neither necessary nor appropriate.

- 1.3 If the FSA believes that even were the current regime to be better understood and more rigorously policed, there would remain a small subset of unsuitable products falling outside the CIS definition, the JAC believes that any further definition need only be narrowly defined. The JAC would strongly suggest that the definition of non-mainstream pooled investments in the Consultation Paper is too wide as currently framed and could catch products that are entirely suitable and desirable for ordinary retail investors.

The Consultation Paper states that the FSA is aware that mainstream structured products can, or do, take the legal form of securities issued by SPVs and that the proposed rules are drafted to ensure that these products are not caught by the marketing restrictions on non-mainstream pooled investments<sup>6</sup>. The JAC agrees with this approach but in the view of the JAC the proposed definition of non-mainstream pooled investments would, as currently drafted, catch mainstream structured products as it captures all securities issued by an SPV other than a very narrow category of exempted securities. Given the relatively limited range of “problem” reference assets highlighted in the Consultation Paper (i.e. TLPs, land, forestry, crops, property and wine) a simpler and more proportionate approach would be for the non-mainstream pooled investments definition to specify a defined and finite list of prohibited reference assets. This approach seems preferable to having a very broad definition of non-mainstream pooled investments coupled with a waiver system. This is because relying on a waiver system in this context leads unnecessarily to commercial uncertainty, additional costs<sup>7</sup> and delays. If, notwithstanding this, the FSA wishes to retain a broader definition then at a minimum the JAC would suggest that the category of exempted securities<sup>8</sup> should be expanded to include securities linked (directly or indirectly) to a wider range of assets than those currently proposed.

The Consultation Paper refers several times to the FSA’s concerns being in relation to SPVs which are functionally most similar to UCIS<sup>9</sup> and that the intention is to capture structured products where the risk profile or investment strategy are in effect non-mainstream by virtue of their reference assets<sup>10</sup>. The JAC considers that an approach which focuses on the type and quality of the underlying assets is the correct approach in principle but is concerned that the current drafting of the definition of non-mainstream pooled investments does not, as drafted, work as intended. The Consultation Paper describes the reference assets which it is concerned with as being those which are inherently speculative and high

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<sup>5</sup> For example, paragraphs 1.9-1.12, Annex 1 paragraph 11 and Annex 2 paragraph 9 of the Consultation Paper

<sup>6</sup> Paragraph 2.14 of the Consultation Paper

<sup>7</sup> The time and cost burden will fall on both providers and the FSA and, ultimately, is likely to lead to increased costs for the products.

<sup>8</sup> Clause (c)(iii) of the definition on non-mainstream pooled investments.

<sup>9</sup> Paragraph 3.24 of the Consultation Paper.

<sup>10</sup> Paragraph 3.26 of the Consultation Paper.

risk, which have a very limited secondary market and are therefore potentially illiquid, and are difficult to value accurately<sup>11</sup>. The JAC would suggest therefore that the category of exempted SPV issued securities in the definition of non-mainstream pooled investments be expanded to include those which reference other assets, in addition to listed shares and bonds, that also carry well understood risks and are liquid and easy to value, for example recognised indices, or indices made up of assets that are liquid and easy to value, traded commodities and FX rates to name a few examples. The JAC would welcome the opportunity to work with you in developing this list.

Furthermore, the JAC notes the FSA's stated intention that structured deposits are not intended to be caught by the proposed rules<sup>12</sup>. The JAC agrees with this approach but would suggest that as a structured deposit can be linked to an index, a stock or a commodity<sup>13</sup>, the FSA should not consider these to be inappropriate reference assets and that SPV issued securities linked to these reference assets should equally be excluded from the definition of non-mainstream pooled investments.

The JAC would also suggest that securities issued by an SPV in compliance with the Prospectus Directive<sup>14</sup> and which are themselves liquid should not be caught by the definition of non-mainstream pooled investments. Such securities must have complied with the disclosure and information requirements set out in the Prospectus Directive (as implemented into the relevant national laws) and have been approved by national financial regulators and are typically admitted to trading and listed on regulated markets. As a result of being admitted to trading and listed on a regulated market, these securities may be subject to the continuing disclosure requirements set out in the Transparency Directive<sup>15</sup> (as implemented into the relevant national law).

- 1.4** The FSA has recognised in its Consultation Paper that SPVs can encompass a wide range of corporate and financial uses and that mainstream structured products issued by SPVs are not the target of the Consultation Paper. The JAC would like to emphasise the legitimacy of using SPVs in structuring products and reiterate the JAC's long held belief that, from a consumer protection standpoint, what should be important is a focus on the overall risk/reward proposition for the investor rather than on a particular legal "wrapper". As the FSA is aware, it is possible to deliver similar products through a variety of legal forms. It would be rare that the form of the wrapper itself is determinative as to whether a product is, or is not, suitable for ordinary retail investors. Different legal forms of delivery obviously have their own nuances but an increase in complexity of structure, for example by using an SPV, does not necessarily result in increased risks to investors. There will be perfectly legitimate non-SPV products that have a higher overall risk than many SPV products.

Indeed, SPV structures can be deliberately designed to reduce risks to investors, for example by segregating specific assets that back the product and to which the investors have recourse (as opposed to taking unsecured credit risk on a product provider). In the view of the JAC, many retail investors have benefited, and continue to benefit, from structures which use SPVs. The JAC believes that by bringing all but a very small number of SPV issued securities within the definition of non-mainstream pooled investments the

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<sup>11</sup> Paragraph 2.3 of the Consultation Paper.

<sup>12</sup> Paragraph 3.28 of the Consultation Paper.

<sup>13</sup> As set out in the FSA Handbook glossary a Structured Deposit is 'a deposit paid on terms under which any interest or premium will be paid, or is at risk, according to a formula which involves the performance of:

(a) an index (or combination of indices)(other than money market indices); or

(b) a stock (or combination of stocks); or

(c) a commodity (or combination of commodities)'

<sup>14</sup> Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading.

<sup>15</sup> Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.

FSA significantly limits consumer choice and unnecessarily prevents retail investors from accessing the potential benefits which SPV issuances can provide.

- 1.5 Finally the JAC would like to express its concern at the territorial scope of the proposed rule changes. The Consultation Paper proposes rule changes, the stated aim of which is to protect ordinary retail investors in the UK. The JAC is concerned that the effect of the eCommerce Directive and COBS 1, Annex 1, Part 2 will be that the rules will in fact also apply to out-bound promotions from the UK to investors within the EEA and that this was not the intention of the proposals. This could put UK firms in a worse position than their EEA counterparts in markets where there is no equivalent restriction on local providers.

## 2 Consultation Response

- 2.1 ***Question 1: Do you agree that we should look to impose restrictions on the promotion of non-mainstream pooled investments to ordinary retail investors?***

As set out in paragraph 1.1 above the JAC agrees with the aims of the Consultation Paper however the JAC is concerned that the proposed rules go further than is necessary to achieve those aims.

As set out in paragraph 1.2 above, in the view of the JAC, the current FSMA definition of a CIS<sup>16</sup> is wide enough to catch the majority of the products the FSA is concerned with. The creation of a new definition of ‘non mainstream pooled investments’ to define UCIS and close substitutes introduces an additional and unnecessary level of complexity.

- 2.2 ***Question 3: Are there any investments caught by the non-mainstream pooled investment definition in the draft rules that you believe should not be?***

Yes. As set out in more detail in paragraph 1.3 above the JAC considers that the definition of non-mainstream pooled investments is too wide. The definition as set out in the draft rules will catch more products than would appear to be the intention of the Consultation Paper.

In addition to the points raised in paragraph 1.3 the JAC would also make the following points. The JAC assumes that it is not the FSA’s intention to consider financial products such as ETCs<sup>17</sup> as non-mainstream pooled investments. These products are admitted to trading and listed on regulated markets and the aim of the product is simply to track the performance of an underlying asset or market (e.g. commodities). The JAC would emphasise that commodity tracking products have been available for many years now, are widely available and well-understood. In the view of the JAC, ETCs should not be put in the same category as the types of complex products linked to underlying assets, the valuation of which may prove to be more difficult in the absence of an established/mature market or independent price sources (such as, for instance, for wines, watches or forests), which the Consultation Paper is concerned with. The commodities that constitute the underlying asset of an ETC have been traded by investors on established and mature markets for an extensive period of time and provide liquidity and most importantly, the independent and impartial (price) transparency via well-established, recognised and reputable service providers. Furthermore retail investors have access to public websites to verify pricing information on these products and the underlying reference asset.

The JAC notes that the Consultation Paper refers to the draft rules excluding from scope SPV-issued securities, whether or not they are structured products, where the returns are

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<sup>16</sup> Section 235 of the Financial Services and Markets Act 2000 (“FSMA”)

<sup>17</sup> Exchange traded commodities (“ETCs”) are products that give investors an exposure to a particular commodity or a commodity index and that are listed and actively traded on exchanges. ETCs are often structured as securities issued by special purpose vehicles. The special purpose vehicle gains exposure to the commodity or commodity index either by investing directly in the underlying commodity or through a derivative contract with a counterparty. ETCs typically have one or more financial institutions who act as “authorised participants” and who make a market in the ETCs.

determined by reference to listed stocks (including baskets of stocks) or one or more stock market indices<sup>18</sup>. We would note, however, that the definition set out in the draft rules is broader - referring to shares and bonds rather than stocks. Consistent with our prior comments, we agree with this broader drafting.

**2.3 *Question 8: Do you agree that we should limit the ability of firms to promote QIS, securities issued by SPVs and TLPIs in the retail market?***

As set out in more detail in paragraph 1.1 above, the JAC agrees that the inappropriate distribution of UCIS and close substitutes to retail investors should be prevented. However, as set out in paragraph 1.3 above we do not agree that the limits should apply to such a wide range of securities issued by SPVs. The JAC is of the view that when deciding which securities issued by SPVs should be included in the definition of non-mainstream pooled investments the focus should be on the reference asset. The aims of the FSA, as set out in its Consultation Paper, can, in the view of the JAC, still be achieved whilst allowing permissible reference assets to include reference assets that are not currently contemplated by the Consultation Paper but that are equally well understood, liquid and easy to value as listed bonds and shares.

Whatever the scope of permissible reference assets, the JAC would like the definition to make clear that the exposure of the product to such permissible reference assets may be direct or indirect. Where the exposure to a permissible reference asset is indirect, for example through the use of a derivative, warrant, certificate, preference share or other financial instrument, the product should not be prohibited purely on the basis that such instrument would not itself be a permissible reference asset.

**2.4 *Question 9: Do you have any comments or suggested improvements for our approach to SPV-issued securities including structured products?***

As set out in paragraph 1.4 above the JAC would like to emphasise that the use of an SPV does not automatically increase the risk to investors and that in many structures the use of an SPV has been beneficial to the investor. As explained in more detail in Paragraph 1.3 and in the answer to question eight above, the JAC considers that the focus should be on the potential risks posed by the reference asset and not on the structure of the instrument used to deliver the investment.

**2.5 *Question 13: Do you agree that the CF10 individual is the correct person to confirm compliance?***

In the view of the JAC, the requirement that the individual registered as CF10 must confirm in respect of each promotion of a non mainstream pooled investment that there has been compliance has the potential to create practical difficulties in firms that have larger compliance departments. We would suggest that the rules should allow for the delegation of the approval of the promotion to relevant members within the compliance function.

**2.6 *Question 17: Do you have any comments on our analysis of non-mainstream pooled investments?***

As set out in paragraph 1.2 and in the answer to question 1 above, the JAC does not believe that an additional definition of non-mainstream pooled investments is necessary to achieve the aims of the Consultation Paper.

However if the FSA believes that the definition is required to catch the seemingly small subset of products which should be caught but that would fall outside the CIS definition then, as set out in paragraph 1.3 above, the JAC is of the view that the current definition of non-mainstream pooled investments is too wide and would catch many mainstream SPV issued securities contrary to the stated intention of the Consultation Paper. In the view of

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<sup>18</sup> Paragraph 3.27 of the Consultation Paper

the JAC it is crucial that changes are made to the definition of non-mainstream pooled investments to avoid retail investors being unnecessarily prevented from investing in mainstream structured products that are suitable and desirable for ordinary retail investors.

The JAC notes the FSA reference<sup>19</sup> to the fact that over the course of 2011, 500 structured products issued by SPVs were launched, and of these the FSA considers that only 27 would fall within the definition of non-mainstream pooled investments. Given the breadth of the proposed definition of non-mainstream pooled investments, this seems low. The JAC would be keen to better understand the manner in which the FSA has been applying the proposed definition to those 500 products they surveyed.

Please let us know if it would be helpful to discuss our response.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Timothy R Hailes', written over a horizontal dashed line.

Timothy R Hailes  
Chairman, Joint Associations Committee

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<sup>19</sup> Footnote 23 of the Consultation Paper.

## **About the Joint Associations Committee**

The JAC is sponsored by multiple associations with an interest in structured products, including the International Swaps and Derivatives Association (ISDA), the International Capital Market Association (ICMA), the Association for Financial Markets in Europe (AFME), the British Bankers' Association, the Asia Securities Industry & Financial Markets Association (ASIFMA), SIFMA, the Associazione Italiana Intermediari Mobiliari (ASSOSIM), the Institute of International Finance, Inc. (IIF) and the UK Structured Products Association (UK SPA). The members of the JAC comprise most of the major firms (both financial institutions and law firms) involved in the creation and, to some extent, distribution of structured securities which are distributed to retail investors.

## **About ISDA**

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 825 member institutions from 57 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

## **About UK SPA**

The UK Structured Products Association (UK SPA) is an organisation established by the UK's leading companies that create and distribute structured products to the UK financial services market in order to provide a useful and responsive source of information, education and comment on structured products by promoting their contribution to effective financial planning.

The UK Structured Products Association is committed to publishing research, information and educational material about structured products and so create greater acceptance about their potential.

The UK Structured Products Association is not a commercial organisation and education and research are its core activities.