Statutory Instrument Response

HMT: Consumer Composite Investments (Designated Activities) Regulations 2024

12/01/2024

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **HMT: Consumer Composite Investments (Designated Activities) Regulations 2024**. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.[1]

AFME Members are supportive of HMT's initiative for a reformed retail disclosure framework.

Definitions

The new definition (and name) of Consumer Composite Investment (**CCI**)

"***Consumer Composite Investment***" *means—*

(a) an investment, or

(b) an insurance product,

other than ***excluded products****, where the amount repayable is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor*."

AFME Members have the following comments on this definition:

1. Members make the general observation that the definition of CCI replicates the existing definition of a PRIIP. This definition is high level and broad in nature and as a result caused significant legal uncertainty as to its scope when it was first introduced. Some examples of this are set out below. It is therefore important to consider the benefits of more specificity within the definitions in the SI and the list of exclusions.

[1] AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is registered on the EU Transparency Register, registration number 65110063986-76.

2. Members have observed that the following amendment to the positioning of the drafting of the definition of CCI is an important clarification to avoid any inference that a product would only qualify as excluded where it meets the second half of the CCI definition:

> "*consumer composite investment" means— (a) an investment, or (b) an insurance product~~, other than excluded products,~~ where ~~the~~ **any** amount repayable is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor**, other than excluded products**;"*

3. Corporate bonds: FCA PS22/2 made certain clarifications to the scope of the PRIIPs regime with respect to corporate bonds, making it clearer that certain common features of these instruments do not, of themselves, turn a corporate bond into a PRIIP.

   This clarification was deemed necessary by FCA (and the market) to provide manufacturers and distributors of corporate bonds with more confidence to issue bonds accessible to retail investors without an accompanying KID where they have been reluctant to do so before due to the lack of express legislative clarity on the point. The clarification was intended to increase retail access to higher quality instruments that benefit from wholesale market pricing.

   We note HMT's position in drafting the SI that it is intended that the FCA's rules will provide further detail on excluded products in due course and understand that this would replicate the approach up to now. However, AFME believes it is essential that the legislation itself is clear on the scope of products caught by the rules. This would increase certainty and clarity, as well make good use of the legislative freedom the UK now has, compared to the earlier approach, which was constrained by the text that had been negotiated in the European trilogues.

   Such increased clarity would also reduce the material risk that access to retail bonds continue to be limited in the UK, as was, and sometimes still is the case under the EU PRIIPs Regulation (notwithstanding the joint ESAs supervisory guidelines on the point).

   We therefore strongly recommend that this important regulatory clarification, as currently articulated in DISC 2.2.2 to 2.2.5R of the FCA Handbook, is more appropriately defined in the drafting of the statutory instrument within he list of excluded products (and then remains in DISC for ease of reference by the reader). We look forward to engaging with the FCA with regard to any updates to the DISC rules that might be required.

4. Consumer Duty alignment: As a general matter, Members would recommend that the scope of the CCI regime should be aligned with limbs (2) and (3) of the carve-outs from the definition of "retail market business" as used in the Consumer Duty rules, as This would ensure that, for example, activities carried on in relation to non-retail financial instruments and primary market business are appropriately excluded.

5. "Retail" not "Consumer" : Members highlighted the inconsistency between the title of "*Consumer* Composite Investment" and the legislative scoping being limited to "retail investors" in this context, particularly given the complexity and breadth of the FCA's separate definition of "consumer". Members

would suggest that HMT consider substituting the word "retail" for the word "Consumer" in the term "Consumer Composite Investment," as this would be more aligned to the type of investors in scope for the designated activity.

6. Shares: Members further consider that the list of excluded products should reference "shares". Shares would not be in scope as they are direct, rather than packaged, investments. However, since the list of excluded products does reference "shares in the capital of any central bank", we deem it important to clarify that this does not indicate that other types of shares should be deemed in scope.

7. OTC derivatives: In case of OTC derivatives, we suggest an outright exemption for products entered into bilaterally where there is no "investment" – i.e., interest rate swap, FX swap, FX forwards, FX non-deliverable forwards, which are used to mitigate the risk of rise or fall and volatility of interest rates, foreign exchange and commodities. The existing FCA rules, derived from MiFID, MiFID II and the Consumer Duty, are sufficient to ensure appropriate disclosure to "investors" in risk mitigating hedging products.

8. Definition of "retail investor": Members note that the definition of "retail investor" in the draft SI aligns with UK MiFIR and excludes professional investors. Members support this approach.

9. Meaning of "made available to UK retail investors"

   £50,000 threshold: Members note that FCA reduced the threshold for "non-retail financial instrument" in the Consumer Duty to £50,000, in line with HMT's proposed approach in the UK Prospectus Regime review for the exemption for wholesale non-equity securities. In this respect, this SI should also be consistent with the UK Prospectus regime and the Consumer Duty.

   We note the existing FCA guidance in DISC 2.3.1G of the FCA Handbook which clarifies when a financial instrument is not made available to retail investors. Namely, when:

   a) Marketing materials: the marketing materials feature prominent and clear disclosures to the effect that the financial instrument is only being offered to professional clients or eligible counterparties and is not intended for retail investors;

   b) Distribution strategy: the issuer of the financial instrument or, in relation to secondary market offers, the distributor, has taken reasonable steps to ensure the offer is directed only to investors eligible for categorisation as professional clients or eligible counterparties; and

   c) Denomination: a denomination or minimum investment of **£100,000** or equivalent amount (calculated within 3 days of the date of issue) applies to the financial instrument.

   Given the conflicting positions within the FCA Handbook, we suggest that the SI takes the opportunity to confirm the definition of "made available" as aligned with the concept of "non-retail financial instrument" in applying the **£50,000** threshold.

In addition, we believe that the existing conditions in the FCA Handbook DISC 2.3 Guidance should be non-cumulative, to further align with UK Consumer Duty (please see Annex A for technical drafting suggestions) .

10. Discretionary managers: Members also consider it would be helpful to clarify that CCI's that are acquired by professional discretionary asset managers would not be "made available to UK retail investors" since the decision to invest rests at the level of a professional investor. This aligns with the interpretation of the existing PRIIPs regime: ESMA Cross-cutting PRIIPs KID RTS Questions (Q1).

    We also have concerns about "advising on a CCI", which relate to the fact that the corresponding definition in the RAO of "advising on investments" is so broad that it includes recommendations that are not personal meaning, for example, that sending a client a research report that covers multiple equity instruments would qualify as "advising on investments". Our concern is that if "advising on a CCI" is defined here in a similarly broad manner, then sending a client a research report that covers multiple CCIs could also require the sending of KIDs (or whatever the new version in the UK is called) for all the CCIs mentioned in the report, even where there is no personal recommendation to the client in relation to any of them. We are concerned that this would be confusing for the client, as well as onerous for the market generally. Having said that, we understand your intention to draft the powers broadly and will engage with the FCA when they draft the scope of the rules to explain our concerns with the breadth of the concept and ensure that there are no unintended consequences.

11. Overseas persons:

    Members would value further clarity on how the CCI framework will interact with the regulated activities and the financial promotion regimes, especially in the case of overseas firms that currently rely on the overseas person exclusion to service UK clients, but also more broadly to understand how activities would be analysed that, for example, fall both within the FPO and the CCI.

    We assume that, consistent with recent ministerial statements, the Government intends for London to remain as open a financial centre as it has been in recent decades, and that there is no intention to restrict the operation of the OPE via the DAR/CCI regime, However, having seen only part of the framework, Members are concerned that the current drafting of the CCI regime, for example might capture third country firms that are currently able to market their products to certain categories of FPO exempt retail investors without entering the financial promotions perimeter. Members would welcome engaging with HMT on this topic.

    Members support giving the FCA the ability to disapply civil liability for breach of specific CCI rules. However, it is not clear whether the FCA will decide to apply or disapply the regime. This presents legislative uncertainty where an overseas entity approaches a UK retail investor under the existing Overseas Person Exemption and offers them a CCI. The effect of the SI would be to increase the liability when an overseas entity approaches a UK investor for CCIs compared to the current position. The FCA approach should not actually or potentially increase liabilities. We look forward to engaging with the FCA on this matter.

12. Made available in the secondary market: Members consider that the draft SI text should be interpreted such that active marketing or solicitation qualifies as being "made available" in the secondary market, whereas simply quoting an indicative ask price does not (see further at paragraph 15 below).

13. "Offering a consumer composite investment": Members note that in line with existing market practice in relation to the definition of "selling a PRIIP", onwards distributions in the context of secondary market trades would not fall within the definition of "offering" a CCI in this context. By way of example, a structured investment product may be closed to new subscriptions but remain subject to a technical listing. In that context an issuer may offer a buy-back bid price facilitating a secondary market. This is not an "offer" and therefore, under the current PRIIPs regime, no KID is produced in this context. UK legislative confirmation on this point would be welcomed.

14. It should also be made clear that "offering" excludes situations where a CCI is offered to retail investors via professional discretionary managers (see paragraph 10 above) as follows: "*offering a consumer composite investment" means communicating sufficient information on— (a) the consumer composite investment to be offered, and (b) the terms on which it is offered, to enable the* ***retail investor*** *to decide to buy the consumer composite investment in question, and includes selling a consumer composite investment*;"

15. "Manufacturing a consumer composite investment": In the context of the Consumer Duty implementation work, FCA amended the definition of "underwriting" to make clear that it related to insurance and credit activities. This avoided the implication that the Duty applies to primary market activities involved in underwriting the issuance of securities. Members consider it is important to make a similar clarification in the SI to avoid underwriting banks having liability for the production of a CCI which they do not in fact manufacture the relevant investment. Noting there is a distinction under the current regulatory regime between "manufacturing" a PRIIP, which in a primary markets context is generally deemed to be the issuer of the transferable security, and "manufacturing" in the context of the product governance regime, whereby an underwriting bank may be deemed "manufacturer" of a new issuance of securities. AFME members do not support the widening of the definition of "manufacturing" within the SI to include underwriters of primary market issuances.

16. Members also consider that the inclusion of limb (b) within the definition of "manufacturing" will create practical issues where a firm falls within limb (b) but not limb (a): "*manufacturing a consumer composite investment" means— (a) creating, developing, designing, issuing, managing, operating, carrying out, or underwriting a consumer composite investment, or (b) making changes to a term, condition, or feature of a consumer composite investment;*" Members therefore suggest that limb (b) is removed and that limb (a) provides adequate coverage for the purposes of the scope of the DAR regime.

Cost benefit

Whilst Members consider the existence of a coherent framework on retail investment disclosures to be beneficial for firms and investors in the long term, Members would like to flag that the repeal of the UK PRIIPs regime, and the implementation of a new retail disclosure regime, will generate large scale upfront costs associated with constructing and testing the additional and/or alternative infrastructure required to manufacture and/or distribute products with complying documentation. The expenses could include a large overhaul of firms' IT systems and processes, as well as staff training. This will be burdensome for firms and may in the short term also slow down the time to market for products within the UK generally. For this reason, Members encourage HMT to work with the FCA to consider a format for retail disclosure that can leverage the existing operational build that is operative in the production of PRIIPs KIDs.

Firms were hit with a large upfront cost to adjust to the UK RTS changes that came to effect in the beginning of 2023. Substantial divergence from the RTS would render these changes futile. To limit further costs for firms, Members would encourage HMT & FCA to grandfather the ability to use existing UK PRIIPS documents and to consider whether the new rules could be flexible enough to facilitate compatibility and comparability with the European KID, within the UK. This would allow the distribution of more products to UK investors at a lower cost than if the same instruments needed to have entirely different UK KID disclosures.

We note that change and uncertainty is always expensive for firms, so it is important to be selective with reviews and to maintain backward compatibility as much as possible to reduce the costs of compliance. Therefore, we do not support (or at least query the usefulness of) the requirement on HMT to review the CCI rules at least every 5 years.

Annex A

DISC 2.3 Guidance on when a PRIIP is not 'made available' to a retail investor

G 25/03/2022

In the *FCA's* view, and for the purposes of the *PRIIPs Regulation*, a *financial instrument* is not 'made available' to a retail investor where one of the following conditions ~~are~~ is met:

(1)

the marketing materials for the *financial instrument* (including the *prospectus*, if there is one) feature prominent and clear disclosures to the effect that the *financial instrument*:

(a)

is being offered only to investors eligible for categorisation as *professional clients* or *eligible counterparties* under the *FCA's rules*; and

(b)

is not intended for retail investors;

or

(2)

the *issuer* of the *financial instrument* or, in relation to secondary market offers, the distributor, has taken reasonable steps to ensure the offer and any associated promotional communications are directed only to investors eligible for categorisation as *professional clients* or *eligible counterparties*; ~~and~~ or

(3)

a denomination or minimum investment of ~~£100,000~~ £50,000 applies to the *financial instrument*, or equivalent amount for a *financial instrument* denominated in another currency, where the equivalent amount is calculated not more than 3 *business days* before the date of issue of the *financial instrument*.

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