Allia C&C

Allia C&C response to CP20/8

Marketing speculative illiquid securities to retail investors

1. Summary

Allia C&C and its parent charity Allia Ltd have raised around £0.7 billion since 1999 through bonds[1] issued for charities and organisations delivering high social impact.

The bonds have taken five forms set out below, the last four of which are currently active:

- Regional zero coupon bonds – unlisted securities raised from a mix of institutional and retail investors for local causes;
- Community Bonds – unlisted securities for amounts of £1.0m plus, substantially raised from ESG investors and supporters of the borrower, for instance school parents and alumni;
- Scottish Housing Bonds – where Allia C&C provides loans, funded by the Scottish Government, to regulated Scottish housing associations;
- Retail Charity Bonds – retail-eligible bonds issued by a special purpose vehicle, where proceeds are loaned to individual named charities for business development purposes; each bond is listed on the Official List of the London Stock Exchange, sold via a prospectus compliant with the European Prospectus and Transparency Directives and reviewed by the FCA, and bought by a mix of retail and institutional investors;
- Corporate bonds – listed securities issued by mid-sized companies (or a special purpose vehicle in the borrower's group).

All of these transactions involve substantial due diligence and credit research to ensure the viability of the transaction (in the case of RCB, involving independent credit research reports), oversight from a group of independent and experienced trustees and directors, and (except in the case of the Scottish Housing Bonds) detailed public disclosure in a prospectus or prospectus-type document and regular updates on performance following issue.

None of the borrowers to date have failed to meet their debt service or other contractual obligations.

We recognise and share the concerns of regulators on the failures of certain mini-bond issues, which have left investors with significant losses and damaged the reputation of the market as a source of attractive investment opportunities.

As we point out in section 3 below, the problems arise from a scarcity of high-quality listed public bonds available to investors in retail denominations.

Bond funds do not provide an adequate substitute for this as:

- They involve expensive management fees and, more importantly,
- They fail to provide a predictable income stream of the type available on an individual bond.

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[1] We define a bond as a loan paying a fixed rate of interest on its face value, repayable on a predetermined date and documented as a freely transferable security.

The failure of the listed market to address the demand for these bonds has given rise to the move into mini-bonds, which are often poorly documented and lack appropriate verification.

We are therefore supportive of measures to restrict the sale of speculative and poorly-structured illiquid products to retail investors, though we believe this should be accompanied by moves to free up the listed public market to retail investors.

We are also conscious of harmful unintended consequences arising from previous attempts to address areas of abuse through, for instance, the Packaged Retail and Insurance-based Investment Products regulations and the Key Information Document requirements which inhibit the use of terms aimed at protecting investors (such as the Spens redemption clause which compensates investors for lost return if a fixed rate bond is repaid early) and require the publication of certain calculations that often provide retail investors with inaccurate and misleading information. We consider it essential therefore that any regulation in this area is carefully considered and tested to ensure that it achieves the right balance.

In this respect, for all mini-bonds (and not limited to just SISs), we believe that:

1. Greater emphasis should be placed on the quality of the credits being offered to retail investors. There was clearly an abject failure on certain mini-bonds to:

    a. analyse or explain the risks investors were being exposed to;
    b. specify or verify the performance of the underlying assets or investments; and to
    c. seek independent verification of the above.

    For listed securities, the Prospectus Regulations mandate the information that must be presented to prospective investors. We consider that the rules relating to direct offer financial promotions should be enhanced to create a similar set of requirements for offers of unlisted mini-bonds, ensuring that issuers provide full and appropriate information, particularly with regards to detailed risk factors.

2. Similarly, the Listing Rules mandate the ongoing information requirements for an issuer of listed securities, including in relation to the UK Corporate Governance Code and the Market Abuse Regulations. We consider that the terms of any issue of unlisted mini-bonds should commit the issuer to adhering to a code of governance requiring a comparable level of disclosure and transparency.

3. Where bonds are issued by intermediary funding vehicles making investments in one or more underlying companies that are not in the same group as the issuer, such vehicles should be governed by independent boards of directors to provide appropriate oversight and approval of transactions.

Without this requirement for accountability we suspect that any changes will simply open up further loop holes for the unscrupulous or optimistic to offer securities to the public.

While therefore we are generally supportive of the proposal for the SIS rules to be made permanent, we do not think this is an adequate response to deal with the abuses of previous years.

Proposed changes to the TPI rules

We also have two significant concerns about the proposed amendments to the rules:

1. **The regular trading test**

   Most listed corporate bond issues are not liquid. The proposal to bring listed bonds into scope is based on whether they are 'regularly traded'. There is no definition of what this constitutes and no objective means of determining whether a particular bond would be in scope.

   Furthermore we consider regular trading is not necessarily relevant where the securities have a registered market maker.

2. **SPV structures**

   It is proposed that SPV structures be excluded where investors have a look-through exposure to the underlying borrower.

   However the draft handbook text considers only 'single-company holding vehicles' – which in our experience are not common in market practice – and does not allow for SPVs which make multiple issues, each looking through to a different single underlying company on a limited recourse basis.

   This risks catching vehicles like Retail Charity Bonds PLC, which goes through a rigorous process of scrutiny, oversight and disclosure on underlying credits and has been designed to serve multiple borrowers in order to reduce the high costs of issuing on a regulated stock exchange.

2. About Allia C&C

Allia C&C is part of the Allia charitable group, a community benefit society formed in 1999 for the purpose of issuing bonds to retail investors to fund community initiatives.

Allia C&C (a brand name of City & Continental Ltd) is an FCA-regulated firm in the Allia group which arranges finance for charities, impact organisations and other responsible businesses, and provides bond services to regulated financial intermediaries and professional investors.

One of the main ways it arranges funding is through the issue of retail-eligible bonds, including:

- **Retail Charity Bonds (RCB)**. This platform was established in 2014 and makes it affordable for charities to raise relatively small amounts of finance from mainstream investors through bonds that are listed on London Stock Exchange and admitted to trading on the Order book for Retail Bonds (ORB).

  The bonds are issued by an SPV, Retail Charity Bonds PLC, and the proceeds of each bond are advanced to a single charity under a loan agreement. The limited recourse provisions in the bonds ensure that investors in each case are only taking credit risk on the relevant single underlying charity and not on any other charity that has received funds from a different series of bonds.

  Full details of the underlying borrower are provided in the prospectus while investors are provided with regular updates on the performance of the borrower through the publication of regular RNS notifications, audited accounts and social impact reports.

- **Community bonds**. Since the RCB platform is limited to minimum issue sizes of £10m, Allia has established another SPV in its group called Allia Social Impact Investments Limited (ASIIL).

  ASIIL is also a community benefit society and exempt charity. The community bond platform works in the same manner, where an issue of bonds provides a loan to a single underlying charity. The bonds are not high yielding and are typically promoted mainly to the relevant charity’s supporters.

  Broadly the same issues of disclosure apply as on RCB.

- **Corporate bonds**. Allia C&C has significant experience in arranging the issue of retail-eligible listed bonds for mid-sized companies, particularly in housing, care, education, real estate and alternative lending.

3. Background

The demand for bonds with retail denominations.

There has always been strong demand for listed fixed-income bonds from retail investors keen to lock into a predictable flow of income over a specific period of time from credit-worthy borrowers.

This demand was met by providing for small denominations on most public issues and was fuelled by two things during the first decade of the 21st century:

- the growth of execution-only brokers, providing investors with an efficient and cost-effective way of accessing and holding the bonds; and
- the creation of tax-efficient savings vehicles like ISAs and SIPPs.

Demand was then stimulated by the relatively poor performance of bond funds during the financial crisis in 2007-8, which highlighted the level of management fees investors were required to pay as a percentage of interest income and the dependence of income on holdings of subordinated bank capital instruments and active trading.

One of the great problems faced by these investors was the reluctance of larger market makers to make transparent prices in the bonds in small amounts.

This was recognised by the London Stock Exchange when it launched the Order Book for Retail Bonds in 2010 to encourage and enhance trading in the securities.

While this initially stimulated retail activity, it faced considerable resistance from established lead managers and institutional investors who promptly categorised issues with retail denominations as "non-benchmark" – thus limiting demand.

It also faced difficulties created by various European Directives including the Prospectus Directive which made issuing retail denomination bonds a more expensive and tortuous process.

This all had the impact of restricting supply to a level where it was inadequate to meet the demand for bonds in retail denominations as well as restricting investors' ability to diversify their risk.

The gap was filled in two ways:

- the issue of unregulated "mini-bonds", many of which lacked the disclosure or transparency of listed public securities; and
- crowd-funding platforms, largely focused on riskier sub-investment grade credits.

The impact was particularly severe on charities and other high social impact organisations that lacked an appropriate mechanism to reach out to their natural ESG-focused retail support base to raise debt as well as donations.

Allia C&C is supportive of the attempts by the FCA to create a level playing field by extending regulation to cover activity in the unregulated market, but we consider that it is equally necessary to do this by relaxing or removing the impediments to retail investment in the wider listed bond market.

We look forward to the FCA's forthcoming discussion paper and to engaging further with the FCA to propose ways that this could be accomplished.

4. Responses to the consultation questions

Q2: Expanding the scope to listed bonds which are not regularly traded

We are aware that a listing in an EEA jurisdiction does not necessarily provide any liquidity advantage to investors. However we believe that the focus on trading fails to understand or address the fundamental issue – namely the suitability of the security. The ability for retail investors to trade their securities is secondary to this. Bonds are generally not traded as actively as equity[2] and are more likely held for income rather than capital gain.

A listing on an exchange such as London Stock Exchange involves a high level of independent scrutiny and verification of the bonds on offer. We consider that this is sufficient to ensure that retail investors are provided with full and clear information to enable them to determine the risk and suitability of an offer of bonds. Accordingly we would argue that bonds listed on a recognised investment exchange (as defined in the FCA glossary) should not fall within the scope of the SIS regulations.

We acknowledge though that the standards are not always as high with other EEA exchanges, and that in such cases the question of whether retail investors have reasonable opportunity to realise their investment may become material. However the concept of 'reasonable opportunity' is challenging. The draft handbook text proposes reliance on a 'regular trading' test, but no means has been provided of objectively determining for any particular security whether this test is met. It would be even more difficult to make any objective determination of whether, for a new issue, it could be expected to be met when trading begins.

At present the bonds issued through the RCB platform are only out of scope of the TPI rules on the basis that they meet the criteria for being 'readily realisable'. They would otherwise fall within the definition of SIS given that they have denominations of less than £100,000 and the proceeds of each issue of bonds are loaned to an entity that is not in the issuer's group. Without the carve-out we have described above for bonds listed on a recognised investment exchange, the FCA's proposed changes to the exemptions would create ambiguity as to whether the RCB bonds are in scope or not.

While retail bonds typically have higher levels of ticket numbers than institutional bonds, they are nevertheless generally traded less regularly than shares. Investors often take a 'buy-to-hold' approach to benefit from regular coupon payments rather than seeking to make gains on price movements. Our sense is that this is particularly the case where investors are strongly motivated by the ethical nature of their investment. With RCB bonds this is further compounded by the relatively small issues sizes.

On the face of it this could lead an observer to conclude that RCB bonds are not 'regularly traded'. However, every bond admitted to trading on ORB must have at least one registered market maker that commits to providing daily two-way executable quotes. This means that the retail investor always has an option to sell his or her bonds, and the regular trading test is not relevant.

We therefore advocate that the draft handbook text is amended at 4.14.19 to read:

> For the purposes of *COBS* 4.14.18R, and notwithstanding the exemption for *readily realisable securities* in COBS 4.14.20R(3)(c), a *debenture* is also a *speculative illiquid security* if:
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> (1) it meets the conditions set out in COBS 4.14.18R; and

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[2] As demonstrated by the difficulty of introducing MIFID/MiFIr transparency obligations on trades in corporate bonds – according to ICMA at the time, "Corporate bonds constitute the largest category with almost 39,000 (out of 61,761) instruments, of which 0.4% are deemed liquid. In other words, 99.6% of corporate bonds are eligible for pre-trade transparency waivers and post-trade publication deferrals due to their illiquid trading status".

(2) it:

   (a) is admitted to official listing on an exchange in the *United Kingdom* or an *EEA State* other than a *recognised investment exchange*; ~~and~~

   (b) is not regularly traded on or under the rules of such an exchange; ~~or~~ and

   (c) no *market maker* has been appointed in respect of the *debenture*; or

(3) it:

   (a) is a newly issued *debenture* which can be reasonably expected to be admitted to official listing on an exchange in the *United Kingdom* or an *EEA State* other than a *recognised investment exchange*; ~~and~~

   (b) cannot be reasonably expected to be regularly traded on or under the rules of such an exchange when it begins to be traded~~.~~; and

   (c) no *market maker* has been appointed in respect of the debenture.

Please also note that we consider there to be a typographical error at 4.14.19(3)(b) where we believe the paragraph should read "**cannot** be reasonably expected…" rather than "can be reasonably expected…".

We also propose that the FCA consults on a definition of 'regularly traded' to provide clarity to the regulations.

Q3: Excluding SPV structures

SPVs are commonly used in capital market arrangements for efficiency and cost reduction. As acknowledged by the consultation paper, in some cases the bonds issued by an SPV will be passed to a specific underlying borrower such that the credit risk taken by the investor is the same as if the bonds had been issued directly by the underlying company.

SPVs are sometimes set up by borrowers, such as housing associations, to enable them to borrow in the capital markets. In these cases the bonds issued by the SPV would be exempt from the TPI rules on the basis that the SPV is part of the underlying borrower's group (whether by virtue of ownership or control).

In other cases SPVs are created by financial services intermediaries, such as ourselves. However it is uncommon in our experience that an SPV would be created to raise funds only for a single company that is not in the same group. Presumably the FCA has seen instances of this but we are not familiar with them. More commonly the SPV would be set up to support the intermediary's services for multiple clients. Each issue may provide funds for a single underlying borrower, but ring-fencing of the assets permits the same SPV to be used on a repeat basis for different borrowers.

This is the case for both the RCB platform and the ASIIL community bonds platform. Each issue of bonds is secured on a loan by the SPV to a single underlying borrower. Issue 1 funds a loan to borrower A, and issue 2 funds a loan to borrower B. Furthermore, the limited recourse provisions in the bonds ensure that investors only have recourse to the relevant loan and not to any other assets of the SPV. Investors in issue 1 are therefore taking credit risk on borrower A: they cannot look to the loan to borrower B if A defaults; equally a default by B would not affect them and would only affect the investors in bond 2.

In other words, to paraphrase paragraph 3.30 of the consultation paper, the function of the SPV is purely to hold the investment in each underlying company, in each case giving investors a 'look-through' exposure to

the underlying company. We consider that this is comparable to investing directly in the same underlying company.

On this basis we agree with the proposal to introduce an exclusion for SPV structures for single-company investments. However we consider that the treatment of financial promotions would not be consistent if the exemption were extended only to 'single-company holding vehicles' as currently drafted and not to SPVs lending to multiple single-companies on a limited recourse basis.

We therefore advocate that references to a 'single-company holding vehicle' be amended to refer to a 'look-through issuing vehicle' defined as:

a single *body corporate* which:

(1) is only able to carry on the following activities:

(a) issuing *debentures* or *preference shares* for the purpose of investing the relevant proceeds of each issue in *shares* or *debentures* issued by a *single company* (without prejudice to the ~~*single-company holding*~~ *look through issuing vehicle*'s ability to constitute the vehicle);

(b) investing the total proceeds of the relevant issue of *debentures* or *preference shares* ~~it issues~~ in *shares* or *debentures* issued by a *single company* and no other *company*~~, and has no discretion in relation to the proceeds of the issue~~; and

(c) paying returns to investors in each issue of *debentures* or *preference shares* in sums equal to any income it receives from the *shares* or *debentures* it owns in the relevant *single company*, including income from any sale of ~~the~~ such *shares* or *debentures*, on a pro rata basis, less any reasonable fees (without prejudice to relevant legislation governing companies and taxation); ~~and~~

(2) has adequate arrangements in place to ensure that:

(a) the proceeds of each ~~the~~ issue are protected and not used for any purpose outside of (1)(b) above; ~~and~~

(b) the recourse of investors in each issue of *debentures* or *preference shares* is limited to the *shares* or *debentures* issued by the relevant a *single company*; and

(c) in respect of each issue of *debentures* or *preference shares* either:

(i) income from the relevant *single company* is held by the ~~*single-company holding*~~ *look through issuing vehicle* on trust for investors on terms that ensure that those investors receive the full amount they are entitled to according to (1)(c) above; or

(ii) the investors have security over the income from the relevant *single company* on terms that ensure that those investors receive the full amount they are entitled to according to (1)(c) above;~~ and~~

(3) ensures that neither the *single company*, nor members of its *group*, will use any of the monies received from the ~~*single-company holding*~~ *look through issuing* vehicle directly or indirectly for one or more of the purposes in COBS 4.14.18R(2)~~.~~; and

(4) otherwise has no discretion in relation to the use of proceeds by any *single company*.