Response to the HM Treasury's Consultation on Regulation of non-transferable debt securities (mini-bonds)

Submission by the Transparency Task Force, July 21st 2021

About the Transparency Task Force

The Transparency Task Force is a Certified Social Enterprise, meaning that we exist to make an impact, not profit.

The mission of the Transparency Task Force is to promote ongoing reform of the financial sector, so that it serves society better. Our vision is to build a large, influential and highly respected international institution that helps to ensure consumers are treated fairly by the financial sector.

The primary beneficiaries of our work will be consumers; but the sector itself will also benefit through improved market conduct and increased trust in the services it provides.

Our objective is to carry out a broad range of activities that help to drive positive, progressive and purposeful finance reform, such as:

- Building a collaborative, campaigning community; the larger it is the more influence it can have in driving the change that is needed
- Raising awareness of issues; so that society better understands the problems that exist in the financial sector and how they can be dealt with
- Engaging with people who can make change happen; because through such dialogue we can influence thinking, policy making and market conduct

Much of our focus is on rebuilding trustworthiness and confidence in financial services. To make this possible we are busy developing a framework for finance reform which we describe as a "whole system solution for a whole-system problem" as described in our recently published book.

Our response to you has been produced by a highly collaborative group of TTF volunteers, our "Response Squad," working together to build consensus, whilst always remaining true to our "North Star" question: "What is best for the consumer?"

For further information about the Transparency Task Force see:
http://www.transparencytaskforce.org

Introduction

There is an urgent need to reform the regulation of the financial services sector because far too many people are exposed to the risk of economic crime, especially as only about 1% of police budget is earmarked towards fighting fraud, even though it is now the most common of all types of crime.

Most people lack the knowledge, experience and expertise to make well-informed, balanced decisions about their finances and as such they are vulnerable to being manipulated by unethical "professionals" and outright criminals. We believe they ought to be properly protected by a robust regulatory framework.

However, there is a mountain of evidence that we do not yet have a robust regulatory framework - the reports by Dame Gloster on the FCA's handling of LC&F and Raj Parker on the FCA's handling of Connaught alone substantiate our point that there is ample scope for the FCA to up its game.

It is therefore vital that the entire regulatory framework is strengthened and that includes the regulation of mini bonds.

Parliamentary Evidence

The TTF's Mark Bishop and Andy Agathangelou gave evidence to the Compensation (London Capital & Finance plc and Fraud Compensation Fund) Bill Committee on 15th June, 2021. Our comments are relevant to this consultation so we would like our testimony at that hearing to be included as part of this submission. It can be viewed here:
https://parliamentlive.tv/event/index/cb6096eb-ee30-4bff-a348-c2133c7a88c0?in=10:44:57 and read here:
https://hansard.parliament.uk/commons/2021-06-15/debates/0f94eb94-b4b1-4439-8857-989412739b85/Compensation(LondonCapitalAndFinancePlcAndFraudCompensationFund)Bill(FirstSitting)

Response to Questions:

Q1. Do you consider that the issuance of NTDS, where the proceeds are then used to on-lend or invest in third party projects, have the characteristics of a financial services activity? Please explain your thinking.

Yes, because the claimed intent is to make a profit through the management of capital, rather than through the operation of a 'real economy' business.

However, the use of the test implied by the above sentence is flawed, because it ignores a number of factors, including:

- The fungibility of money. A firm that claims it is issuing bonds to support its own operations may also invest some money in third party activities. It may be difficult or impossible to prove whether the money raised from bond purchasers is used for the former purpose or the latter;
- The challenge of defining 'third party'. In London Capital & Finance, bond purchasers were told their money would be loaned to third party businesses; in practice, most recipients were controlled, beneficially owned or both by the principals of LC&F. In that particular case, the links were easy to establish; in some others, 'third parties' may be difficult or impossible to identify as a result of the use of offshore structures or undeclared third party borrowers (commonplace in peer to peer frauds);
- Genuine, diversified third-party lending may not be the problem. As the examples given above illustrate, many of the losses occasioned by consumers in financial services scams occur through schemes in which the claimed intent is to lend to low-risk third parties, but in fact loans are made to disclosed or undisclosed connected borrowers. They then default, the money having been dissipated. We call these bad faith lending schemes (BFLS). These expropriate consumers' money by breaching their reasonable expectation that loans will be made to unconnected parties using best endeavours to avoid or minimise defaults. They adopt a wide range of structures, including Unregulated Collective Investment Schemes[1], peer to peer lending[2], secured bonds[3] and so-called mini-bonds[4], exploiting regulatory loopholes, regulatory incompetence and asymmetries of information (a particular structure falling out of fashion as

[1] Eg Connaught Income Fund Series 1
[2] Eg Lendy, Funding Secure
[3] Eg Secured Energy Bonds
[4] Eg LC&F, Blackmore Bond

scheme failures of that type achieve widespread media coverage, alerting prospective victims and making it harder to launch new scams using that structure)

Q2. What are the benefits and drawbacks of making the direct-to-market issuance of NTDS a regulated activity?

It is a step in the right direction, but falls far short of reaching the destination. The shortcomings of this measure, taken in isolation, are:

- It would not cover sales of NTDS via intermediaries. Although in theory those parties are separately regulated, in practice there are legitimate concerns about the extent and competence of the supervision of the channels that would most likely be deployed for the distribution of NTDS, namely crowdfunding and peer to peer platforms and introducers operating under the Appointed Representative (AR) regime;
- The measure would encourage regulatory arbitrage, with the architects of BFLS re-engineering their products to prevent them being caught by the NTDS regime. For instance, they could hold out that investors' money was to be used within the business itself or in connected party firms;
- There is nothing in this proposal that targets the creation of BFLS through structures unrelated to bonds, despite the prevalence of such activity

Q3. Do you agree that making the direct-to-market issuance of NTDS a regulated activity by providing a specific exception to Article 18 of the RAO is more proportionate than bringing its issuance within the scope of the MiFID framework? Please explain your thinking.

This is a complex question, made even more complicated because of the difference between perception and reality in relation to the regulated activity that has been taking place. For example, with LC&F the money was used to lend to companies within a group controlled by the same principals as the firm that sold the bonds, which we understand means that MiFID did apply.

However, the FCA appears not to have noticed that this form of regulatory activity was taking place, nor has there been, *ex post*, any attempt to sanction the perpetrators for breaches of those rules - indeed, the FCA has actively promoted the myth that regulated activity was not being carried out.

Q4. Do you think that the provision of a prospectus would better inform retail investors when choosing whether to invest in NTDS? Please explain your thinking.

Yes, as long as that prospectus was clearly written, with authentic transparency in mind. The financial services sector is known for failing to communicate in a clear and intelligible way, with excessive use of technical jargon and legalese.

If the prospectus is not easy to understand it should not be accepted as being compliant.

Q5. What are the benefits and drawbacks of extending the provision of the Prospectus Regulation to the issuance of NTDS?

We at the Transparency Task Force believe that the existing Financial Promotions Regime (FPR) is broadly unfit for purpose, and have made a number of recommendations for its enhancement or replacement in our response to HM Treasury's Consultation on Financial Promotions (2020).

In particular, we believe that firms wishing to attract capital from consumers into investment schemes, which would include NTDS and 'real economy mini bonds' (REMB), should be required to issue prospectuses that are first registered with the Financial Conduct Authority under a regime not dissimilar to the Securities Act of 1933 that governs such activities in the United States of America.

As evidence for the need for such a measure, take LC&F. Contrary to the assertion made in paragraph 1.3 of your consultation, the firm *did* initially need a third party to approve its promotions, because it was not initially authorised by the FCA. Such approvals were provided by Sentient Capital London Limited. At the time of writing[5], the firm's entry in the FCA Register indicates that it still enjoys a clean disciplinary history, with no restrictions placed on its ability to approve further promotions, despite it manifestly having approved misleading promotions for LC&F, a fact of which Dame Elizabeth Gloster's report finds that the FCA became aware as long ago as January 2016. Moreover the two individuals holding control functions in the firm, James McGrath Dolan and Neil Butland, are also free of any FCA or PRA regulatory and disciplinary action, so both are at liberty to continue their careers - despite their involvement in LC&F, and their previous roles with Beaufort Securities Limited. The act of approving wilfully misleading promotions, preceded by another allegedly criminal misconduct case, does not appear to have impinged on their ability to approve further promotions.

Clearly, creating an environment in which consumers can have a reasonable expectation that any financial services product they purchase is as described, and that the perpetrators will be prosecuted

[5] 27 May, 2021

and banned from the industry should that turn out not to be the case, requires more than a legal obligation on a firm to register every prospectus with the FCA. There is also a huge job to be done to fix the regulator: its governance must be transformed[6]; there must be an actionable duty of care on the part of both firms[7] and the FCA to consumers and small businesses, backed up by a complaints scheme that's fully compliant with the requirements of the Financial Services Act 2012[8]; and there must be radical change to the senior leadership, recruitment and retention policies and organisational culture of the FCA.

Until these measures are taken, simply changing the rules to which firms are subject creates additional costs for the honest majority without materially impacting outcomes for bad actors; it therefore risks amounting to displacement activity. In conclusion, it is largely pointless without regulatory reform; but with it, it could be a valuable step toward rebuilding public confidence in the financial services market.

Q6. Do you consider that relying on existing FCA and HMT measures is sufficient, meaning that further regulation of non-transferable debt securities is not required?

No. The problems with the FCA's temporary ban on the mass marketing of speculative illiquid securities (SIS) is that not all SIS are fraudulent or even high-risk - so there is consumer and societal detriment involved in an outright ban - and that the regulation can easily be gamed. For instance, an NTDS may be described as lending to the recipient firm and its subsidiaries rather than third parties, fungibility exploited to conceal the use of funds to support the acquisition of assets or development of property. Indeed, for a good-faith actor, such activities - which may bring with them security tied to the acquired or developed assets - may reduce rather than increase risk for consumers, so a regulatory response that incentivises the concealment or avoidance of such activities, perhaps through the elimination of such security, could act counter to consumer interests.

We are unimpressed by proposals for the FCA to operate a gateway through which firms must pass before being allowed to approve third party promotions. As evidenced in our answer to questions 4 and 5, even when a firm has been proven to have misused this power, and with reasonable grounds for doubting the integrity of its directors, the FCA has failed to act to remove the company's or its principals' permissions, so we are sceptical about the regulator's operational competence to operate such a gateway.

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[6] We advocate, among other things, the creation of a consumer-oriented oversight board, the Financial Regulator's Supervisory Council (Appendix III, Treasury Task Force response to HM Treasury's Consultation on Financial Services Future Regulatory Framework Review)

[7] Which should include an enduring liability on the part of firms approving promotions for unauthorised firms to consumers who rely on those promotions

[8] See our response to the FCA consultation 'Complaints Against the Regulators' (CP20/11)

Q7. Are there any other credible options that may better address concerns around the issuance of NTDS, whether instead of, or alongside, those considered here?

We take the view that neither NTDS nor REMB are the problem, though some may be vehicles for it. The real problem is BFLS. The core BFLS proposition as communicated to consumers is an attractive one: diversified, often asset-backed and guaranteed, income-generating loans. If they operated as described, there might be a legitimate place for such products in many retail investors' portfolios, and a societal benefit to the availability of such capital.

The challenge with BFLS is the obvious economic incentive for those who sell or manage such products to 'lend' the money to declared or (if they're smart) undeclared connected parties, which then dissipate the money then default.

The blunt force, incomplete fix is to ban any product category used for BFLS. Sadly, scammers are generally more capable and more motivated than most regulators, so will simply keep finding new ways of packaging BFLS. The more nuanced, more effective approach is a combination of controlling the marketing of all financial services products, supervising them more closely and aggressively prosecuting and banning firms and individuals found to have perpetrated or enabled misdirection of such funds.

A further consideration, relating to the "Halo Effect"

It is our view that one of the biggest problems in the LCF case was the "halo effect" of FCA regulation as Dame Gloster described it, plus the regulatory perimeter.

Many retail investors only put money into LCF because it was regulated and therefore they assumed it was a credible entity, especially as there was no warning sign that it was only partially regulated.

BBC journalist Paul Lewis wrote an excellent article on the topic:- *"Ministers should not pass the buck on LCF mini-bonds"* where he states "*To solve this problem in the future, regulated firms should not be allowed to sell unregulated products, or the perimeter should be flexed so any product sold by a regulated firm is regulated*".

We believe there is great merit in that point.