Client Alert

August 11, 2014

CoCo No-Go for Ordinary Joe

The UK's Financial Conduct Authority, on 5 August 2014, announced the introduction of new temporary product intervention rules in relation to the retail distribution of contingent convertible instruments (CoCos).

The Financial Services Act 2012 introduced new temporary product intervention powers for the FCA and this represents the first time that these temporary intervention powers have been applied, although the FCA has previously exercised other intervention powers in relation to the distribution of Unregulated Collective Investment Schemes and other Non-Mainstream Pooled Investments.[1]

CoCos are debt instruments which, by their terms, convert into equity instruments or have their principal amount written down, without the consent of the instrument holder, upon one or more specified trigger events. The occurrence of one of these specified trigger events will usually indicate a significant financial deterioration of the instrument issuer, and the consequent conversion or write down of principal will have the effect of absorbing losses and improving the issuer's financial situation, since it will reduce the issuer's debt burden. CoCos are usually issued by financial institutions and form part of their capital funding structure, ranking in seniority somewhere in between their share capital and their unsecured senior debt. Depending upon their exact features, they may also meet the requirements to qualify as tier 1 or tier 2 regulatory capital, where the institution is required to maintain regulatory capital pursuant to the Capital Requirements Regulation in Europe or other Basel-related regulations in other countries.

As a result of the recent implementation of the new, more stringent Basel III regulatory capital requirements, as well as national provisions (such as in the UK) requiring the holding of more loss-absorbing capital and requiring certain employee remuneration to be in the form of loss-absorbing capital, regulated institutions will over the coming years have a much greater need to raise loss-absorbing capital. The FCA is therefore concerned that institutions will have a strong incentive to target not only institutional investors, but also ordinary retail investors. However, it considers that the complex loss-absorbing features of CoCos present investment risks that would be exceptionally challenging for ordinary retail investors to evaluate. Therefore, in the FCA's view, this presents a significant risk of CoCos being inappropriately promoted to ordinary retail investors, who may be attracted by their comparatively higher coupon, compared to other simpler debt instruments in the current, low-interest-rate environment.

As a result the FCA has announced that it is using its temporary product intervention powers to impose restrictions on the promotion or intermediation of CoCos to ordinary retail investors during a 12-month period

[1] See Morrison & Foerster's Structured Thoughts article at http://media.mofo.com/files/Uploads/Images/130617-Structured-Thoughts.pdf .

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commencing on 1 October 2014. In conjunction with this temporary product intervention, the FSA has announced that it will also launch a consultation paper in September 2014 in relation to proposed permanent rules on the promotion and distribution of CoCos, with the aim of any final permanent rules taking effect from 1 October 2015, when the temporary rules expire.

The contingent convertible instruments that are being targeted by these temporary rules are defined as instruments which qualify for treatment as Additional Tier 1 Capital under article 52 of the Capital Requirements Regulation (CRR) or as Tier 2 Capital under article 63 CRR, where the terms of that Tier 2 instrument require the permanent or temporary write down of principal, or the conversion of the instrument to Common Equity Tier 1 instruments, in each case upon the occurrence of a trigger event.

The FCA has not explained why it is focusing these temporary intervention rules only on instruments that qualify as regulatory capital under the CRR. Given that the FCA's stated reasons for focusing on CoCos were their riskiness[2] and their complexity, it seems strange that the proposed determining factor as to which instruments are caught by the prohibition is the instruments' regulatory capital treatment. It is to be hoped that the consultation in September 2014 will aim to develop a more nuanced description of which instruments should be subject to the permanent rules.

The temporary rules provide that a firm may not sell a CoCo to a retail client or do anything that would or might result in a retail client buying, or holding a beneficial interest in, a CoCo. This will apply to primary market issuance and sales, as well as to sales in the secondary market.

In terms of geographical scope, the rules apply to all authorised persons in the UK and focus only on retail clients in the EEA, unless they fall within one of the exempt types of retail investors. These exemptions include certified sophisticated investors, as well as certified high-net-worth investors and self-certified sophisticated investors, subject to the firm having carried out a suitability assessment for those individuals.

Where the prohibited activities amount to MiFID or equivalent third-country business, the prohibition only extends to the communication or approval of a financial promotion.

Also exempted is investment advice to any retail client that has made a specific request to the firm for advice on the merits of investing in the CoCo, where that client has not previously received any financial promotion or communication from the firm intended to influence investment in CoCos.

The temporary rules also clarify that the prohibition does not apply to the following activities:

- distributing any prospectus required pursuant to the Prospectus Directive;
- in relation to issuers of CoCos only, the subsequent trading in the secondary market of the CoCo;
- clearing, registration, or settlement of transactions in CoCos, any back office processing or reporting of such transactions, or custody of CoCos; and
- the acquisition of beneficial interests in CoCos held by virtue of participation in a regulated collective investment scheme, investment in a non-mainstream pooled investment, or membership of an occupational pension scheme.

Although it is not conducting any consultation process in relation to these temporary rules, the FCA has welcomed

[2] Which is an odd comment, since these instruments are less risky than investing in ordinary shares of the relevant institution, and there is no proposal to subject ordinary shares to product intervention.

any comments from interested parties in respect of ways in which the proposed drafting of the rules departs from their intended effect, particularly before the rules come into force on 1 October 2014.

Firms wishing to engage in a broader discussion of the merits or otherwise of product intervention in relation to CoCos will have to wait for the formal consultation on the permanent rules when that is launched in September 2014.

Authors

Jeremy C. Jennings-Mares
London
44 (20) 79204072
jjenningsmares@mofo.com

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