Complaints Commissioner

Office of the Complaints Commissioner
Tower 42
25 Old Broad Street
London EC2N 1HN

Tel: 020 7877 0019
E-mail: info@complaintscommissioner.org.uk
www.frccommissioner.org.uk

15 November 2022

Final Report by the Complaints Commissioner

Complaint number 202200900

The complaint

1. On 22 January you asked me to review a complaint on behalf of your client about the FCA in connection with London Capital & Finance plc (LCF). A Preliminary Report was issued to you and the FCA on 17 February 2022. This Preliminary Report concluded that three allegations of the five grounds of the complaint were new and the FCA had not had a chance to review them first. Under the Complaints Scheme (the Scheme) to which both the regulators and I operate to, it is preferable for the FCA to conduct its own investigation first, as that is usually the best way of resolving matters. For this reason, I suggested you refer these allegations back to the FCA for a reply. I explained you would be able to refer the issue to me for an independent review if you were not satisfied with the outcome provided by the FCA.

2. Following correspondence on 28 February 2022 and 4 March 2022, you decided to refer the three allegations back to the FCA for an initial review. I agreed not to issue a Final Report whilst these matters sent back to the FCA as a complaint. The relevant correspondence in the form of a further set of complaints were sent to the FCA by you on 28 February 2022.The FCA issued a further decision on this new set of complaints on 14 June 2022. On 7 July 2022, I informed you that if you wished to refer the FCA's decision to me/or comment on the Preliminary Report, you should do so by 16 September 2022. You responded to me on 16 September 2022 by referring the FCA decision letter dated 14 June 2022 for my review and submitting comments on my Preliminary Report dated 17 February 2022.

3. You have expressed your view that it would be in the public interest for the whole file of documents you have submitted to be appended to my Final Report.

4. I have considered your request, however, I have decided not to include any appendices in my report. I rarely include appendices, and, in my view, there are no grounds for doing so here. The documents that both you and the FCA have provided are voluminous, however, I consider that I have captured the substance of the subject matter sufficiently in my report. I do not consider the appendices add any further expansion of the substance of the main arguments, and I must be mindful that the Complaints Scheme is not an alternative to a court hearing.

What the complaint is about

5. The regulator summarised your complaint as follows in its decision letter dated 4 January 2022:

> Part One
>
> You disagree with the FCA's decision to label LCF's products as "mini-bonds."
>
> Part Two
>
> You disagree with the FCA's statement that "LCF's Bond Instruments made clear that its bonds were not transferable."
>
> Part Three
>
> You consider that the conclusions and directions in the FCA's Supervisory Notice "are back-to-front, in giving precedence to the LCF documentation concerning non-transferability instead of giving precedence to the status of LCF bonds at the point of sale or issuance as an ISA product issued by an approved ISA provider. Those provisions of the documentation which afford transferability must prevail as a matter of contract law and not those provisions that prejudice consumers. Provisions asserting non-transferability must be regarded as invalid under the Consumer Rights Act 2015.
>
> Part Five
>
> The FCA's guidance on "mini-bonds" as issued on 17 May 2019 was inaccurate in stating unequivocally that issuance of such products is always unregulated.

Part Six

The FCA has repeatedly taken positions which are opposed to the interests of LCF bondholders.

It is worth noting that in your letter dated 22 October 2021, you confirmed that your client no longer wishes to complain about Part Four of his original complaint.

6. The FCA summarised your complaints as follows in its decision letter dated 14 June 2022:

Allegation One

You object to the FCA's use of the term 'mini-bond' because you allege that the FCA has 'loaded' the term in such a way as to negatively affect public perception.

Allegation Two

You allege that the FCA should have developed guidance concerning the status of non-transfer clauses in other consumer bonds and in particular their potential unfairness and unenforceability under the Consumer Rights Act 2015. You ask us to consider the position:

I. prior to LCF falling into administration in January 2019;

II. after the FCA had received correspondence from lawyers acting for certain LCF investors alleging the unfairness of the non-transfer clauses of LCF in May 2019 and September 2019; and

III. after the handing down of the judgment in R (Donegan and others) v Financial Services Compensation Scheme (FSCS) in March 2021.

Allegation Three

You allege that the FCA should have looked into and discovered the unfair terms of the LCF bonds. Specifically, you allege that your letters of June and August 2019 should have provided sufficient evidence to trigger a review by the FCA of the LCF bond terms.

Allegation Four

the FCA statement of 19 May 2019 on mini-bonds lacked sufficient clarity, placing the onus on the reader to join up different pieces of information. This was unhelpful, and it is not unreasonable to expect higher standards of the regulator when it communicates with the public.

What the regulator decided

7. The FCA did not uphold any of your complaints in its decision letter dated 4 January 2022. The FCA did not uphold allegations one, two and three in its decision letter dated 14 June 2022. It declined to respond to allegation four. It said 'this additional allegation was raised following the receipt of the Commissioner's Preliminary Report and is based on a preliminary finding from the Commissioner. In my view, I do not think it is appropriate for the FCA to provide a separate response at this stage. This is a preliminary finding from the Commissioner and both your client and the FCA had an opportunity to respond to the Preliminary Report by 10 March 2022. Paragraph 7.12 of the Complaints Scheme is relevant here. It says, 'The relevant regulator(s) must, in any case where the Complaints Commissioner has reported that a complaint is well founded, or where he has criticised the relevant regulator(s) in his report, inform the Complaints Commissioner and the complainant of the steps which they propose to take by way of response.' Therefore, should this finding from the Commissioner's Preliminary Report remain in her Final Report, the FCA will respond accordingly as per paragraph 7.12 of the Scheme.'

Preliminary points

8. In this report, 'you' and 'your' refers to 'your client'.

9. You have not referred Part Four of your original complaint to me, so this report reviews only Part One, Part Two, Part Three, Part Five and Part Six.

10. You have referred to a judgment handed down on 29 March 2021 in the Judicial Review case of R (on the application of Donegan) v Financial Services Compensation Scheme Ltd) which I will refer to as the Bourne J judgment.

11. I have quoted extracts from your complaint letter where I felt it appropriate to do so. You have referred to London Capital & Finance plc as LC&F, whereas my report refers to it as LCF. For the avoidance of any doubt, it is one and the same.

12. You have provided me with various documents and arguments in relation to your correspondence with the Financial Services Compensation Scheme (FSCS) and HM Revenue and Customs (HMRC). I am unable to review complaints or evidence relating to organisations other than the regulators under the Complaints Scheme.

My analysis

Part One - You disagree with the FCA's decision to label LCF's products as "mini-bonds"

Allegation one: You object to the FCA's use of the term 'mini-bond' because you allege that the FCA has 'loaded' the term in such a way as to negatively affect public perception.

13. You complained to the FCA that your client is concerned that the FCA's labelling of LC&F investments as unregulated "mini-bonds" was questionable, misleading and inappropriate. In support of this you say:

    a. LCF bonds were not sold as "mini-bonds". Advertising materials described LCF bonds variously as "corporate bond", "fixed interest corporate bonds", "fixed rate corporate bonds", "fixed interest bonds" and "fixed rate ISAs".

    b. The term "mini-bond" is imprecise jargon with no established legal meaning. It is not defined in the Glossary to the FCA Handbook (which contains thousands of definitions), nor, in relevant primary or secondary legislation.

    c. Any established meaning of the term "mini-bonds" has in the UK only emerged in the wake of, and in response to, LCF's collapse.

    d. The FCA's decision to prohibit direct marketing of speculative illiquid securities, including mini-bonds, to retail investors was also taken after LCF's administration.

    e. The FCA's repeated invocation of the word "mini-bonds" for LCF investments is a matter of contention, which has been picked up by the press and the Gloster Report[1].

[1] Report of the Independent Investigation into the Financial Conduct Authority's Regulation of London Capital & Finance plc

14. The FCA responded that

    a. “mini-bonds” is not defined in legislation or the FCA’s rules. But it is a term that has been used in the market for several years. We believe it usually refers to illiquid debt securities, marketed to retail investors. We are of the view that LCF’s debt securities fell within that commonly understood meaning.’ We also explained ‘In relation to your remarks that investors “believed they were investing in an ISA or other investment product”, we note with sympathy what you say about investors’ belief that they were making a safe and in some cases ISA-eligible investment in products issued by a FCA-regulated firm. However, FSCS protection depends on the activities actually carried on by the relevant person, as required by FSMA and Parliament, not what a person investing with a relevant person may have thought.

    b. The term “mini-bond” was not used by LCF to describe the products it was marketing to consumers, and that Dame Gloster notes in her Report that ‘the term “minibond” is controversial and does not have a legal definition and, as such, is not generally used in this Report.’ However, our view remains that LCF’s debt securities fall within the generally understood meaning of “mini-bond”.

15. The FCA also said the term mini-bond has been in used in the market prior to LCF’s collapse and gave examples of where it had appeared in both FCA and non FCA publications.

16. You referred your complaint to me on 22 January 2022 and made the following remarks:

    a. Most LC&F investors did not think that they were investing in high-risk unregulated mini-bonds, as the FCA's public positioning would have it.

    b. The references to mini-bonds in FCA materials prior to LC&F's collapse are at best obscure, in non-core (embedded) paragraphs of technical papers

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/945247/Gloster_Report_FINAL.pdf

with broader scope that largely concern other topics (e.g. crowd-funding) and have as their intended audience regulated firms (not consumers).

c. That the investments issued by LC&F may fall within the FCA's 2019 definition of mini-bonds is not in doubt, but this was an intentional outcome on the part of the FCA, since the FCA's "mini-bond" definition was developed in response to events and so was drafted by the FCA with the specific intention of covering LC&F.

d. The FCA has used the term "mini-bond" incessantly, without qualification and without recognition (as far as we are aware, until the FCA January 2022 Letter) that LC&F's products were not labelled as such. The FCA's approach has therefore been in stark contrast to that of all disinterested public sector actors to have considered the matter: for example, HMT refers to them as "non-transferable debt securities"

e. The repetitive usage by the FCA of such a loaded term has without doubt negatively affected public perceptions of LC&F investors.

f. In conclusion you say ‘our client remains of the view, as clearly do many other LC&F bondholders…that the FCA's development of the "mini-bond" concept in 2019 and its ex post facto application to LC&F has been incessant, misguided, insensitive and inappropriate. The [Complaints Commissioner] should consider whether the FCA developed that guidance appropriately or has included appropriate messaging in its multiple references to "mini-bonds" in the materials linked above.’

17. It seems to me there are two distinct issues which need to be addressed as part of your complaint. The first is that you feel the FCA’s reference to LCF investments ought not to be ‘mini-bonds’. As I understand it, you say this is because LCF bonds were not described as mini-bonds at the time of issue and the FCA "mini-bond" definition was developed in response to events and so was drafted by the FCA with the specific intention of covering LC&F retrospectively.

18. You have not directly provided an alternative reference which would distinguish the LCF bonds as non-transferable debt securities, but you have provided an example above of what you consider to be disinterested public sector actors who have considered the matter: for example, HMT refers to them as "non-

transferable debt securities". You have pointed out the Gloster report said it would avoid using the term unless necessary, and that in my report on the FCA's oversight of LCF (https://frccommissioner.org.uk/wp-content/uploads/The-Complaints-Commissioner-Final-Report-LCF-15.02.2022.pdf) states 'As such, my final report will only make reference to 'mini-bonds' where it is imperative to do so'.

19. The second issue is your allegation that the FCA 'loaded the term' (mini - bonds) in such a way to 'negatively affect public perception of LC&F investors'.

20. I will address these two issues in turn.

21. The FCA has used the term 'mini-bonds' prior to the collapse of LCF in order to describe high risk, illiquid debt securities: for example, this definition features in its 2015 thematic review of the regulatory regime for crowdfunding and the promotion of NRRS by other media.

22. You have said the references to mini-bonds in FCA materials prior to LC&F's collapse are 'in non-core (embedded) paragraphs of technical papers with broader scope that largely concern other topics (e.g. crowd-funding) and have as their intended audience regulated firms (not consumers).'

23. I have not investigated your assertion above, as I do not consider it has a direct bearing on the issue at hand. Whether the FCA referred to mini-bonds as illiquid high risk debt securities in technical papers only does not alter the fact that the FCA was already using the term mini - bonds to describe the type of securities LCF was issuing prior to its collapse, and therefore did not develop a *new* (my emphasis) definition of the term.

24. I take your point that LCF investments were not marketed as 'mini-bonds', however, neither were they were marketed as 'non-transferable debt securities' although it has been established that this is what they were.

25. It is the case that the FCA has sought to utilise terminology to differentiate the term 'bonds' as transferable debt securities and the type of bonds which LCF issued, which are non-transferable debt securities. You have commented that you do not think it is necessary to develop terminology differentiating the bonds that LCF issued to other bonds.

You have made the point that you ‘do not advocate usage of the term "non-transferable debt securities" for LCF bonds either. This is because, ‘following R v Financial Services Compensation Scheme, the LCF bonds were in fact transferable (contractually) among consumers as a result of the CRA 2015. It is just that they were found not to be "transferable securities" for purposes of MiFID II.’ The Bourne J judgement states ‘So, an original purchaser who was a consumer would be allowed to effect a transfer, if a purchaser could be found, but the survival of the non-transfer characteristic in the instrument itself would, in my judgment, be inconsistent with the existence of any genuine "capital market" on which the Bonds could be truly negotiable.’

26. In your letter to me of 16 September 2022 you make further detailed representations on this point and say that ‘It is a fundamental part of this complaint that, although the concept of a mini-bond may have existed in some form prior to the FCA developing guidance on the point, it had other meanings and was not supposed to define unregulated investments issued by an FCA-regulated firm for investment purposes (as the FCA then asserted once the LC&F scandal broke).’

27. It is not my intention to list all the further representations you make on this point. There is sufficient information provided by both you and the FCA on this point to see that there is a difference of opinion between you and the FCA as to the terminology (if any) that should be used. The FCA’s position is that it will refer to non-transferable debt securities as mini-bonds. You are of the opinion that it should not and have provided alternative examples where such securities are described exactly as ‘non-transferable debt securities’.

28. With respect to the terminology used, Bourne J concluded ‘it does not matter whether the right term is "bond" or "mini-bond". What matters is the precise nature of the instruments sold and the meaning of the legal provisions applicable to them" (R (Donegan and others) v Financial Services Compensation Scheme at 43).

29. Under the Complaints Scheme to which I operate, I am bound by the findings and decisions of a court.

30. Paragraph 6.15 of the Complaints Scheme provides that

In the investigation of a complaint by either the relevant regulator(s) or the Complaints Commissioner, any finding of fact of:

a) a court of competent jurisdiction (whether in the UK or elsewhere);

b) the Upper Tribunal; or

c) any other tribunal established by legislative authority (whether in the United Kingdom or elsewhere);

d) any independent tribunal charged with responsibility for hearing a final appeal from the regulatory decisions of the regulators;

which has not been set aside on appeal or otherwise, shall be conclusive evidence of the facts so found, and any decision of that court or tribunal shall be conclusive.

Paragraph 6.16 of the Complaints Scheme states 'Any findings of fact or decisions of courts or tribunals not covered by paragraph 6.15 will carry such weight as the regulators or the Complaints Commissioner considers appropriate in the circumstances.'

31. The Bourne J judgment conclusion, which was made after the Gloster report and my own report were issued, and which is binding on me, does not ascribe any adverse or unlawful reference to the use of mini-bond as a term to describe the 'precise nature of the instruments sold and the meaning of the legal provisions applicable to them.'

32. The Bourne J findings, as well as the evidence of the FCA's usage of the term - mini-bonds' to describe non-transferable debt securities well before the collapse of LCF, leads me unable to conclude that the FCA's usage of the term 'mini - bonds' to describe non-transferable debt securities is inappropriate or unreasonable. I understand you disagree with this view, however, that does not change my carefully considered position.

33. It seems to me, however, that your primary objection to FCA's usage of the term 'mini-bonds' is because you believe the FCA has 'loaded' the term in such a way as to negatively affect public perception. You say, the FCA has consistently frequently labelled LC&F ISA investments as "mini-bonds", "high risk" or

"unregulated". Therefore, you feel the FCA has created a negative public perception about LC&F investors.

34. The FCA reviewed this allegation as allegation one in its decision letter dated 14 June 2022 and did not uphold it.

35. The FCA said that it did not wilfully and intentionally use the term ‘mini-bond’ to create a negative public perception of LCF bondholders, and having reviewed the statements it had issued and which you referred to, it did not think it had done so; it had only identified a need to highlight the risks involved in purchasing mini-bonds, which is a growing market, ‘but a key aim is to raise awareness and to assist investors to identify mini-bonds, not to blame them.’

Part Two - You disagree with the FCA’s statement that “LCF’s Bond Instruments made clear that its bonds were not transferable.”

Part Three - You consider that the conclusions and directions in the FCA’s Supervisory Notice are back-to-front, in giving precedence to the LCF documentation concerning non-transferability instead of giving precedence to the status of LCF bonds at the point of sale or issuance as an ISA product issued by an approved ISA provider. Those provisions of the documentation which afford transferability must prevail as a matter of contract law and not those provisions that prejudice consumers. Provisions asserting non-transferability must be regarded as invalid under the Consumer Rights Act 2015.

36. You asked the FCA and I to treat Parts Two and Three as the same complaint as they essentially refer to the same issue.

37. You clarified that this element of complaint is to be ‘confined to the matters on which Bourne J found against the position of the FSCS (which was also the position of the FCA), i.e. as to the non-enforceability of the non-transfer clauses in LC&F's documentation under the CRA 2015. The FCA had consistently taken the opposite position, i.e. that LC&F's non-transfer terms were fair, contractually enforceable and permitted under the CRA 2015.’

38. You say ‘Our client acknowledges that the effect of Bourne J's judgement in R v FSCS is that the CRA 2015 cannot change the regulatory categorisation of a financial instrument, meaning that the "effect of unfairness" is less extensive

than had been argued by our clients in the Court proceedings. However, the non-enforceability of non-transfer clauses in consumer bonds still has critically important commercial consequences for investors'

39. I summarise the points you have made:

    a. the FCA should, at least after it had received the S&S June 2019 Letter[2] and S&S August 2019[3] Letter, have publicly stated that the non-transfer clauses of LC&F documentation were unfair and unenforceable under the CRA 2015.

    b. the FCA should, at least after the handing down of the Bourne J judgment in March 2021, have developed guidance concerning the status of non-transfer clauses in other consumer bonds (including their concept of "mini-bonds")

    c. The Gloster Report concluded that the FCA's lack of resources did not excuse its lack of action in relation to its regulatory and supervisory failures concerning LC&F. The same conclusion should now be reached by the FRCC as regards the FCA's lack of own-initiative or responsive actions in relation to non-transfer clauses in consumer bonds under the CRA 2015.

40. The background to this element of complaint is that HMRC issued a statement in March 2019 regarding LCF's bonds and that they did not comply with the ISA regulations so were not qualifying investments. This was because they were not transferable securities. The effect of this was that they would not be eligible for FSCS protection.

41. You then entered into correspondence with the FCA (on behalf of your client) in 2019 over several matters, one of which concerned the 'transferability' of LCF ISA bonds.

42. You write in the appendix of your letter dated 29 August 2021 'The transferability of the LC&F Bonds has arisen as a critical issue relevant to the availability of FSCS compensation to LC&F investors'. Much of your correspondence with the FCA on behalf of your clients seeks to assert that LCF

[2] 24 June 2019 Letter from Shearman and Sterling (S&S).

[3] 29 August 2019 Letter from Shearman and Sterling (S&S).

ISA bonds should be regarded as transferable securities, the goal being to enable them to be eligible for FSCS compensation.

43. In your June 2019 letter (footnote 10 page 3) you say that ‘funds held in ISAs must be transferable to alternative ISA investments and so any sale of LC&F must be implied and understood to be a transferable product’, and elsewhere you say that these bonds are ‘legally transferable’’.

44. The FCA replied to you on this point in its letter of 3 July 2019 to say ‘when you say ISA’s are legally transferable we believe that you may be referring to that fact that the qualifying conditions for crowdfunding debentures to be held within an Innovative Finance ISA include that the debenture must be a transferable security; that is clearly correct, but in this respect, LCF’s Bond Instruments made clear that its bonds were not transferable, so they were not eligible for an IFISA’.

45. In your August 2019 letter you say ‘LC&F ISA bonds should be regarded as "transferable securities" as a result of contractual interpretation and the Consumer Rights Act 2015’.

46. The FCA accepted your letter of 29 August 2019 as a complaint under the Scheme on 22 June 2020 and deferred it pending the outcome of the independent review led by Dame Elizabeth Gloster.

47. On 29 March 2021 the High Court handed down the Bourne J judgment. It said the Claimants (on whose behalf you were acting) contended that, as a matter of law, the Bonds were transferable securities and/or that LCF in any event engaged in the regulated activity of agreeing to deal in transferable securities even if the Bonds themselves were not transferable.

48. Bourne J in his judgment at paragraph 119 to 124 said

> I have concluded that an order disapplying the non-transfer provisions in the case of the Claimants would not turn the Bonds into securities which are "negotiable on the capital market" and therefore into "transferable securities" for regulatory purposes. That is for two reasons. First, each of the Bonds would remain a bond constituted by a Bond Instrument which states that it cannot be transferred, although the effect of section 62 would be that that term could not be enforced against any of the Claimants. The

security, as distinct from the contract by which each Claimant acquired it, would retain its original characteristics. In my judgment that interpretation is supported by section 62(3), which enables consumers to rely on an unfair term if they so choose. This indicates that the term in question remains capable of having legal effects even if it cannot be enforced against a consumer. So, an original purchaser who was a consumer would be allowed to effect a transfer, if a purchaser could be found, but the survival of the non-transfer characteristic in the instrument itself would, in my judgment, be inconsistent with the existence of any genuine "capital market" on which the Bonds could be truly negotiable. The second reason is that the Claimants, in my judgment, do not seek merely the disapplication of an unfair non-transfer provision so that they are free to transfer the Bonds. Instead, they are asking the Court in effect to turn unregulated securities into regulated securities. My conclusion, on balance, is that this would go beyond the powers of the Court under section 62. The CJEU cases referred to above repeatedly emphasize that the purpose of corrective action by the court is to restore balance to the parties' transaction. But here, the true purpose would be to give the Claimants a regulatory remedy outside the contractual transaction.'

49. The Bourne J judgment makes it clear that the LCF bonds are not transferable securities for regulatory purposes in paragraph 146.

50. Before the judgment was issued, there was an exchange of correspondence between you and the FCA with differing views on the whether the LCF ISA bonds were 'transferable securities': I have outlined above the references I have seen you made in your letters of June 2019 and August 2019 on the issue of the transferability of LC&F bonds, namely that in your June 2019 letter you say that funds held in ISAs must be transferable to alternative ISA investments and so any sale of LC&F must be implied and understood to be a transferable product, and that these bonds are 'legally transferable', and in your August 2019 letter you say ' LC&F ISA bonds should be regarded as "transferable securities" as a result of contractual interpretation and the Consumer Rights Act 2015.'

51. On 3 July 2019 the FCA responded that 'LCF's bond instruments made clear that its bonds were non transferable, so they were not eligible for an IFISA'.

52. Having reviewed the correspondence between you and the FCA leading up to the Bourne J judgment, I do not find any specific reference by the FCA using the terms ‘the non-enforceability of the non-transfer clauses in LC&F's documentation under the CRA 2015’; and whilst you have pointed out to me you used this terminology in a letter you wrote to the FSCS which was an appendix to a letter you wrote to the FCA, in my view that is irrelevant as it does not evidence any instances where the FCA, as you put it, ‘has consistently taken the opposite position, i.e. that LC&F's non-transfer terms were fair, contractually enforceable and permitted under the CRA 2015’. You have referred me to paragraphs 132-146 of the Bourne J Judgment but that has no bearing on the fact that the FCA has not taken the position you claim it has.

53. You have referred to your correspondence with the FSCS on this topic and refer to an FSCS letter dated 8 January 2020 ("FSCS January Letter"), where the FSCS stated that it had liaised with the FCA. You then say ‘The FSCS January Letter is therefore here assumed to state the FCA's position on the matters referred to therein.’

54. I do not agree that it is reasonable to infer, or assume, as you put it, from the mere statement that the FSCS had liaised with the FCA that the content of its letter reflects the FCA position. I am also unable to review your correspondence with the FSCS under the Complaints Scheme as complaints about the FSCS are excluded. Therefore, I have not considered the letter FSCS sent you as part of my review of your complaint. I have also not considered the many points you raise about your interaction with the FSCS for the same reason.

55. In any event, any matters related to the correspondence between you and the FCA on this issue have now been superseded through the Bourne J judgment, which is binding on me as well.

56. You have expressed your view to all of the above in your letter to me dated 16 September 2022 that your complaint has not been about whether the LCF bonds were transferable for the purposes of MIFIDII and FSMA, and I ‘did not address the fundamental issue of whether or not, in the months following LC&F's collapse in 2019 and early 2020, the FCA took the view that the non-transfer clauses of LC&F were enforceable and/or advocated that position to the

Financial Services Compensation Scheme ("FSCS")', and that I should have 'focused on Bourne J's findings regarding the unfairness of the non-transfer terms for the purposes of the Consumer Rights Act 2015'.

57. I have not said that your complaint seeks to challenge the Bourne J judgment that the LCF bonds are not transferable within the meaning of the relevant statutory provisions. I have reviewed whether, as you stated on 14 January 2022, the FCA had consistently taken the opposite position, i.e. that LC&F's non-transfer terms were fair, contractually enforceable and permitted under the CRA 2015. The issue of whether the FCA influenced the FSCS in any way has been dealt with below.

Allegation Two and Three

58. In your complaint dated 22 January 2022 to me, you say 'the FCA should, at least after the handing down of the judgment in R v FSCS in March 2021, have developed guidance concerning the status of non transfer clauses in other consumer bonds (including their concept of "mini-bonds' as there may be commercial implications if such clauses exist in other bond instruments).

59. You also say that your own letters of June 2019 and August 2019 should have provided sufficient 'intelligence' for the FCA to trigger a review of the LCF bond terms under UNFCOG 1.4.1 (G) and 'the FCA should, at least after it had received the S&S June 2019 Letter and S&S August 2019 Letter, have publicly stated that the non-transfer clauses of LC&F documentation were unfair and unenforceable under the CRA 2015 '.

60. The two allegations above were reviewed by the FCA in its decision letter dated 14 June 2022 where it summarised these points and your additional comments as Allegation Two and Three. I will address them in turn.

61. The FCA summarised Allegation Two as follows:

Allegation Two

> *You allege that the FCA should have developed guidance concerning the status of non-transfer clauses in other consumer bonds and in particular their potential unfairness and unenforceability under the Consumer Rights Act*

You ask us to consider the position:

I. prior to LCF failing into administration in January 2019;

II. after the FCA had received correspondence from lawyers acting for certain LCF investors alleging the unfairness of the non-transfer clauses of LCF in May 2019 and September 2019; and

III. after the handing down of the judgment in R (Donegan and others) v Financial Services Compensation Scheme (FSCS) in March 2021.'

62. The FCA did not agree it ought to have developed further guidance. In summary, it stated that:

    a. 'only a court can determine the fairness of a term and we expect firms to ensure their terms are written clearly and are not unfair under the UTCCRs or the CRA. The FCA has an external webpage titled 'Unfair contract terms library'5. This webpage sets out our past undertakings, agreements and other publications regarding unfair contract terms. The webpage clearly says 'We expect firms to have regard to the material published on this page. In particular, as part of their risk management, firms should remain alert to undertakings or court decisions about other firms, since these will be of potential value in indicating the likely attitude of the courts, the FCA, the CMA or other bodies to similar terms or notices or those intended to have similar effects. This page lists undertakings given to the FCA but does not list undertakings given to the CMA, which can be found on their website, or court decisions.' It goes onto say 'Firms may also wish to seek their own legal advice on unfair contract terms to take account of developments in legislation and relevant case law.' The statement is further supported by the FCA handbook on Unfair Contract Terms Regulatory Guide (UNFCOG) at 1.5.1(4) G.

    b. For the period prior to LCF's administration, UNFCOG 1.4.1 (G) sets out when the FCA will act regarding Unfair Contract Terms (e.g. following a complaint from a consumer or other person or on our own initiative if the term or notice is within our scope) and neither criteria were met in this case. II. It is not necessary for the FCA to issue guidance in every scenario. Only a court can determine the fairness of a term (which had not

happened during this timeframe) and as stated above, the responsibility lies with firms to ensure their terms are not unfair under the UTCCRs and the CRA. III. For the period after the judgment in R v FSCS was handed down in March 2021, I am not persuaded that the FCA should have published guidance either. The FCA Handbook and external website make clear it is a firm's responsibility to take into account court decisions about other firms and apply those to their own contracts'.

63. Your response to the FCA's position is that:

    a. The FCA's webpages on unfair contract terms, "Unfair contract terms" (Unfair contract terms | FCA) and "Unfair contract terms library" (Unfair contract terms library | FCA) make no reference to non-transfer terms as an example of unfair terms. This is despite the clear decision of Bourne J in R (Donegan and ors) v FSCS, in which he held with reference to the LC&F bonds that, "the non-transfer provisions were unfair" (para 132).

    b. Clear FCA guidance on the unenforceability of unfair contract terms is important for the industry and consumers, since non-transfer clauses may lock consumers into products for a long period of time, prejudicing their rights. This is an important issue regardless of the regulatory position as to the definition of "transferable securities". Our client asks that the FRCC considers recommending that the FCA publishes appropriate guidance on the fairness of non-transfer clauses in consumer-marketed securities, which would complement the other steps that it has taken in relation to higher risk securities'.

64. It is clear that there is a difference of opinion between you and the FCA on whether it should provide further guidance on the fairness of terms, and you have both provided your reasons as above. Under paragraph 3.4 c of the complaints scheme, complaints in relation to the performance of the regulators' legislative functions as defined in the 2012 Act are excluded, so technically I would not be able to make a formal recommendation to the FCA to issue guidance or rules. In my view however, although there may be a debate to be had about the merits of the arguments on both sides, it is not my role to substitute my views for those of the FCA. I see my role as determining whether

the FCA's position/actions are within a range of actions which are reasonable for a regulator to take, and in that light, the FCA's position not to issue further guidance as a result of the Bourne J judgment does not seem unreasonable to me.

Allegation Three

65. The FCA summarised this allegation as follows:

> You allege that the FCA should have looked into and discovered the unfair terms of the LCF bonds. Specifically, you allege that your letters of June and August 2019 should have provided sufficient evidence to trigger a review by the FCA of the LCF bond terms.

66. The FCA did not uphold your complaint and said:

    a. The letters you refer to in June and August 2019 were sent after LCF entered administration in January 2019 and after the FCA and Serious Fraud Office (SFO) investigations had been launched into LCF. The FCA's powers under the CRA are to 'seek an undertaking from a firm that it will amend or remove an unfair contract term from its future consumer contracts' or to 'apply to a court for an injunction to prevent a firm from using or enforcing the term against its existing customers,' In my view, raising concerns about the fairness of LCF's terms under the CRA would have had little effect once LCF had entered administration.

    b. your June and August 2019 letters were also after the FCA took regulatory action against LCF using its powers under the Financial Services and Markets Act 2000 (FSMA). On 10 December 2018 the FCA directed LCF to immediately withdraw its promotional material on the basis that the way in which it was marketing its bonds was misleading, not fair and unclear. On 13 December 2018, the FCA also imposed certain requirements (through a Voluntary Requirement or VREQ) on LCF including (a) not to dispose of or deal with its assets, save in limited circumstances, (b) to cease conducting all regulated activity and (c) not to communicate any financial promotions. These actions prevented further harm being caused to consumers.

67. The FCA explained that the FCA's Handbook guidance UNFCOG144 explains the FCA's policy on how it will use its powers under the CRA in relation to unfair terms and consumers notices. UNFCOG 1.4.1 (G) says 'The FCA may consider the fairness of a term or notice within the meaning of the CRA following a complaint from a consumer or other person or on its own initiative if the term or notice is within its scope.'

68. Consumer Contracts Team within the FCA received two referrals about LCF. However, these referrals were not related to unfair contract terms, were received after the FCA's supervisory intervention in December 2018 and were redirected to relevant teams accordingly. The Consumer Contracts Team also did not complete any multi-firm work, relating to contracts terms meeting the fairness and transparency of the CRA, on this sector during the Relevant Period.'

69. You have said of the FCA 'The FCA failed to heed multiple tip-offs in relation to LC&F from industry and consumers and failed to scrutinise the unusual business model of LC&F, as is well-addressed in the Gloster Report. The FCA should further have spotted the large balance (£237 million) of retail investor deposits which were building up at LC&F, which was authorised only for brokerage activities and held only £50,000 of capital against its exposures. Based on either of those two concerns, the FCA could and should have launched a review'

70. I agree that the FCA failed to scrutinise the unusual LCF business model appropriately, however, as you say, this has already been highlighted extensively in the Gloster report and I do not think it is necessary or relevant to pursue this limb of enquiry as I consider the matter to have been dealt with in the Gloster report.

Part Five (as restated) – The FCA's guidance on "mini-bonds" as issued on 17 May 2019 was inaccurate in stating unequivocally that issuance of such products is always unregulated.

71. You say the FCA published this guidance on its website on 17 May:

"Mini-bonds [are] not transferable."

"There is no Financial Services Compensation Scheme (FSCS) protection if the issuer fails"; and

"Issuing mini-bonds to investors is not of itself a regulated activity".

72. You say, ‘Following our letter [dated 24 June 2019], the FCA either removed or amended a number of these statements, replacing them with more balanced (and in our view, more accurate) statements, for instance that "Issuing mini-bonds is not normally a regulated activity" and "mini-bonds do not usually need to be authorised by the FCA."

73. In particular you refer to a statement published on 17 May 2019 which said, ‘Remember that you are not protected by the FSCS if the issuer goes bust’.

74. You asked the FCA to amend the wording to

‘Remember that you are will not usually be protected by the FSCS if the issuer goes bust’.

75. The FCA has now amended the wording.

76. You say the FCA issued no apology for what you allege to be an incorrect statement on its website on 17 May 2019 and instead stood by its original May 2019 guidance in its letter dated 3 July 2019, despite that guidance being clearly wrong and being modified.

77. As remedy, you ask that (i) an apology be issued; and (ii) this complaint be taken into account in the [Complaint Commissioner]’s [annual] report.

78. In its decision letter, the FCA does not deny that on 17 May 2019 it published the text you refer to above, and that it later amended the text in the way you say it did. It says that ‘the statement issued by the FCA on 17 May 2019 was consistent with HMRC’s and the FSCS’s view at the time’, and ‘Our July 2019 letter explained that ‘the FCA has identified a need to highlight the risks involved in purchasing mini-bonds… but a key aim is to raise awareness and to assist investors to identify mini-bonds…..The FCA considered it was important to highlight to consumers the risks involved in investing in mini-bonds and that meant stating clearly that the issuing of mini-bonds is not a regulated activity which benefits from FSCS protection. The statement is valid - if a mini-bond issuer goes bust, consumers won’t be covered by the FSCS just because they

bought a mini-bond. That was the FCA's interpretation of the highly complex and multi-layered perimeter at the time. There are scenarios where consumers might be covered because other regulated activities were carried out in relation to the purchasing of mini-bonds such as advice and this was explained on the same webpage'.

79. The FCA also says that 'The updated statement had 'usually' added to it to reflect the development in the FCA's mini-bond guidance. However, just because the statement was updated, it does not mean the first one was incorrect. The first statement was a valid statement to make at the time as it represented the FCA's guidance on an issue in a 'growing market' and highlighted to consumers that investing in mini-bonds is risky and normally not protected by the FSCS.'

80. You provided a copy and the FCA provided a copy of the statement issued on 17 May 2019, updated on 31 May 2019. My comments are as follows:

81. The FCA did present all the relevant information on 19 May 2019 but in a disjointed way. Several months later, the same information was presented, this time more clearly. The FCA said about the amendment 'We are taking the opportunity to update our statement on LCF to reflect our more developed guidance on mini-bonds'. I note the FCA's explanation however, it seems to me that there was no specific change in guidance in the subsequent rewording. It appears the explanation that 'there are scenarios where consumers might be covered because other regulated activities were carried out in relation to the purchasing of mini-bonds such as advice' which was elsewhere on the page was joined up with the statement that ' Remember that you are not protected by the FSCS if the issuer goes bust' and consequently this became 'Remember that you are will not usually be protected by the FSCS if the issuer goes bust' to include the aforementioned scenarios.

82. Whilst I do not consider the statement issued on the FCA website on 17 May 2019 to be inaccurate, so I cannot uphold this specific complaint, I do find it lacked sufficient clarity, placing the onus on the reader to join up different pieces of information. This was unhelpful, and it is not unreasonable to expect higher standards of the regulator when it communicates with the public.

You referred my opinion above to the FCA as a further complaint, allegation four, which the FCA declined to investigate on the basis that it was raised following receipt of my Preliminary Report and should have been addressed as a response to my Preliminary Report rather than a new allegation. I have not upheld your complaint, however, I have criticised the FCA for how it presented information on its website. The FCA has responded that it does not consider that the webpage lacked clarity or made it difficult for readers to join up the information contained across the webpage, although it subsequently updated the reference to FSCS (see paragraph 81 above). Given the FCA felt compelled to update this information to make it clearer, I do not see how it can argue successfully that the original iteration was clear enough: if it was, there would not have been a need for the update. It is disappointing that the FCA has taken the defensive position it has given the evidence, and my criticism remains unchanged.

Part Six The FCA has repeatedly taken positions which are opposed to the interests of LCF bondholders.

83. You say the FCA has a statutory duty to protect consumers under section 1C of FSMA. You have raised seven points which you believe show how the FCA has "failed to act in accordance with consumer protection objective".

84. You raise seven specific points about the actions of the FCA in support of your assertion above. They are as follows:

85. '*The pinning by the FCA of the novel "mini-bond" label on the LC&F bonds, despite such bonds not being marketed as such'*. This point is addressed under Part One of this complaint.

86. *'The FCA's failure to investigate and address the validity and enforceability of the non transfer clauses on consumers both whilst LC&F was under its supervision and after it fell into administration, a dereliction of its duties as a regulator under the Consumer Rights Act 2015.'* This point is addressed under Part Two and Three of the complaint.

87. *The publication of unequivocal guidance on 17 May 2019, after LC&F had collapsed into administration, that mini-bond activity is unregulated, which*

guidance then had to be corrected.' This point is addressed under Part Five of this complaint.

88. '*The declaration for the first time and novel policy-making accepting the "mini-bond" category as a valid unregulated product-type and endorsing the hitherto unseen (and never repeated) regulatory arbitrage perpetuated by LC&F as a regulated financial institution issuing repayable instruments in an apparently unregulated fashion. According to LC&F and the FCA, this was neither "deposit-taking (because they were in the form of securities) nor "dealing with investments as principal" (because the securities were non-transferable*).'

89. The FCA said the first part of this complaint was covered under Part One and that 'It is a fact of the current legislative framework that regulated firms can carry out unregulated activities. Therefore, the risk that consumers may be influenced by the 'halo effect' is present for many firms regulated by the FCA who (as they are legally entitled to do) undertake both regulated and unregulated activities. This is a feature of the legislative framework which is not within the FCA's control. It is worth noting that it is not always the case that a regulated firm carrying on unregulated activities represents an increased risk of consumer harm, however, firms should make clear to consumers the status of the protection available to them (e.g. access to the Financial Ombudsman Service and the FSCS) under the current regulatory framework.' It did not uphold your complaint.

90. You have pointed out that 'To clarify, our client's complaint and position is not that the FCA has endorsed LC&F or its business model (as is asserted in the FCA's response), but that the FCA took a policy decision to endorse the questionable regulatory arbitrage perpetuated by LC&F, which was at that time a novel regulatory interpretation, one at odds with previous European-level guidance'. You cite guidance from the European Commission in its Impact Assessment from 8 March 2018, which stated that, "MiFID applies in relation to the list of 'financial instruments' set out at Section C of Annex I to the Directive. The financial instruments most likely to be used in investment-based crowdfunding are transferable securities e.g., equities or 'mini-bonds', though others such as units in collective investment undertakings would be possible."

91. The Gloster report reviewed in depth the FCA's oversight of LCF, its unusual use of mini bonds, and the FCA's actions or lack of with respect to this matter during the relevant period. Given the extensive nature of that report, I do not propose to review this point any further. However, the report did not make a specific finding that the FCA took a policy decision to 'endorse questionable regulatory arbitrage perpetuated by LC&F'. You have pointed out that you are referring to the period after the report was published, and in particular its use of the terminology 'mini bond'. I have already reviewed this matter and have nothing further to add to my view as set out under Part One of your complaint.

92. '*The endorsement of (and likely contribution towards) HMRC's declassification of the ISA-eligibility of LC&F bonds (for example in the FCA July letter in which the FCA argued that "LCF's Bond Instruments made clear that its bonds were not transferable, so they were not eligible for an IFISA"). The effect of the HMRC's decision on this point 13 was later reversed in April 2021, allowing ISA benefits to be rolled over by LC&F investors, when HMRC announced that, "We are able to consider only the bonds issued by LCF to be void and not the ISA 'wrapper"*.

93. HMRC voided the ISA status of LCF's bonds on 19 March 2019. The FCA wrote to you on 3 July 2019 (after HMRC's announcement) that 'LCF's Bond Instruments made clear that its bonds were not transferable, so they were not eligible for an IFISA'. The FCA has not investigated your claim formally that it likely influenced or contributed to HMRC's view and statement in March 2019. If you have any evidence which you would like to submit to support this claim, I invite you to send it to the FCA for further investigation. The FCA did however address the other part of your complaint to say 'In April 2021, HMRC issued a further statement that *'following submission of new evidence we have reviewed the position on LCF ISAs. We are able to consider only the bonds issued by LCF to be void and not the ISA 'wrapper' (the subscriptions made or funds transferred to an LCF ISA).'* I note that this statement from HMRC was after our July 2019 letter and after the publication of the Gloster Report and based on the 'submission of new evidence'. This does not mean that our earlier statements were invalid at the time they were issued. In fact, in this case, our view was entirely consistent with that of HMRC at the time'.

94. You have said that in supporting the original 2019 decision of HMRC, the FCA failed to investigate the facts properly and came to incorrect conclusions.

95. The FCA has said it is not within the FCA's remit to consider if LCF's ISAs complied with legislative requirements or to make decisions on a product's tax status. It says when it wrote to you on 3 July that 'LCF's Bond Instruments made clear that its bonds were not transferable, so they were not eligible for an IFISA' it expressed a view which was consistent which was consistent with HMRC.

96. Given that the FCA says it is not its role to consider the if ISAs comply with legislative requirements and make decisions on the tax status on products, it would have been helpful if it had clarified this to you in its letter of 3 July 2019, as well as if it was merely repeating the HMRC statement or whether it had undertaken its own review of the matter to reach this conclusion.

97. However, at the time the FCA wrote to you on 3 July 2019, HMRC had made its own determination on the matter and issued a public statement. Given this determination was within the gift of HMRC, if it was not within the remit of the FCA to formally determine if ISAs comply with legislation, then any discussions with you in July 2019 on this matter would not have had any regulatory impact for LCF investors.

98. HMRC revised its view on LCF ISAs in 2021 due to new evidence: I am unable to review the decisions of HMRC under the Complaints Scheme. I note however, that LCF bonds continue to be deemed non-transferable securities for regulatory purposes.

99. '*Advocacy of the FCA's own position, that LC&F's bond issuance activities were not regulated, towards the FSCS. We understand that during 2019, the FSCS had internally taken the initial view that it would provide broad compensation to LC&F investors who held ISA products on the basis of the Consumer Rights Act 2015, but the FSCS changed its mind following the FCA's advocacy*.'

100. You have based your position above on several emails from the FSCS's disclosures during the judicial review proceedings for (*R (Donegan and others) v Financial Services Compensation Scheme* which were exhibited in the evidence in that case, including:

a. In an internal email from X to certain of her FSCS colleagues dated 17 June 2019, X stated, "I think we need to discuss how we can best move things forward as there is currently a strong view that we may not be making the right determination […] I would like to find a way to move from the view that was expressed by some that we have allowed the FCA to impose an easy for them (FCA) outcome".

b. In an email from Y to certain of his FSCS colleagues dated 1 November 2019, Y stated, "We're waiting on further input from the FCA on the issues that counsel has been considering, so once those have been received, and counsel has finalised his advice, we'll be in touch again", which indicates the FCA may have been applying pressure to the FSCS.

c. In board minutes relating to LC&F dated 19 November 2019, the minutes recorded, "*Agreed that FSCS must discuss with FCA at senior level the impact of this decision*".

d. Propose to the FSCS board that we accept FCA position on Dealing as Principle" [sic]; and "FSCS will bear the brunt of any negative publicity so need to ensure that we have support from FCA and HMRC".

101. The FCA responded as follows: ‘

a. The FSCS’s operational independence is: (i) built into the FSMA framework in s.212(5), which says that the terms of appointment of FSCS directors must secure that operational independence; (ii) reflected in the FCA’s rule-making powers to establish the scheme, which say in s.213(3) that the rules must provide for the FSCS to assess claims for compensation; and (iii) clear in those FCA rules for example COMP 3.2.1R, which says that it is for the FSCS to satisfy itself whether the conditions for compensation are met.

b. It is clearly sensible, as well as mandated by s.217A(1) FSMA, for the FCA and the FSCS to co-operate in the exercise of their functions, given they are often closely linked. This is supported by a published Memorandum of Understanding (MOU)32 including an agreement regarding sharing information (paragraphs 11 to 14).

c. In the case of LCF, there was a large overlap between the issues that the FSCS needed to consider in determining whether to pay compensation to LCF bondholders and matters that the FCA needed to consider in terms of its own work in relation to LCF and connected entities. Therefore, it was appropriate for the FCA and FSCS to co-operate which included co-operating on seeking external legal advice. Each organisation used the external legal advice it received to inform its own independent decision-making – the FCA from a regulatory perspective and the FSCS to help inform their decision on whether the conditions for payment of compensation were satisfied. The email extracts set out in your letter do not, in my opinion, show that the FCA inappropriately applied pressure to the FSCS to make a determination either in favour of or against LCF bondholders. Clearly, it was important to identify if the FSCS could pay compensation based on the COMP rules and the FCA shared information with the FSCS in line with its functions. However, as you point out in your letter, ultimately, the decision was taken independently of the FCA by the FSCS Board'.

102. In any event, Bourne J handed down his judgement on the FSCS decision in relation to paying compensation to LCF bondholders and the claim was dismissed.

103. I have reviewed your claim that the FCA influenced the FSCS in determining whether to pay compensation or not. I agree with the FCA that the email extracts on their own do not prove your claim. However, I have reviewed the FCA investigation file and satisfied myself that although there was liaison between the FCA and the FSCS, I have seen no evidence to suggest that your complaint is made out.

104. You have raised specific points above in support of your allegation that the FCA has breached its consumer protection objective. I do not agree with you that these points provide reasonable grounds to reach a conclusion that the FCA breached its consumer protection objective.

105. I have reached the conclusion above based only on the points you raise, although I am mindful of the Gloster report's finding in a wider sense with

regards to whether the FCA discharged its functions with respect to LCF in a manner which enables it to effectively fulfil its statutory objectives.

106. The Gloster report makes this finding: ‘Paragraph 3(1) of the Direction states that the primary question for the Investigation is “whether the FCA discharged its functions in respect of LCF in a manner which enabled it to effectively fulfil its statutory objectives”. For the reasons summarised in this Executive Summary, and as explained in more detail in the rest of this Report, the Investigation has concluded that the FCA did not discharge its functions in respect of LCF in a manner which enabled it effectively to fulfil its statutory objectives. In all the circumstances, the Investigation concludes that the Bondholders, whatever their individual personal circumstances, were entitled to expect, and receive, more protection from the regulatory regime in relation to an FCA-authorised firm (such as LCF) than that which, in fact, was delivered by the FCA.’

Amerdeep Somal
Complaints Commissioner
15 November 2022