

Question 3: Do you believe the provisions above are sufficient for defining an AFIB for regulatory purposes?

2.6 There were mixed views on whether to employ the tax definition of AFIBs for regulatory purposes or create a unique regulatory definition. On balance, most respondents felt that a unique regulatory definition would be preferable as not all provisions in the tax definition were relevant in the regulatory context.

2.7 More generally, some respondents considered that the definition of an AFIB as set out in the draft statutory instrument was too restrictive and there were additional regulatory requirements which were not applicable to conventional debt securities (article 77 instruments). Others felt that the definition resembled the tax definition¹⁰ too closely and some also felt that another naming convention instead of AFIBs should be used to distinguish between the tax and regulatory definitions.

Our view

2.8 For the sake of consistency we will use the term alternative finance investment bond (AFIB) for regulatory purposes, even though the definitions for tax and regulatory purposes differ. Feedback on specific provisions of the definition of an AFIB is set out below:

Identification of assets

2.9 Respondents indicated that sukuk instruments are not always based on (an) identifiable physical asset(s); others also alluded to the fact that in some sukuk structures the assets purchased are not linked to the underlying return paid (i.e. where the repayment is linked to an index, contractual right or other independent sources, etc.). One respondent suggested that 77A(2)(b) should be amended so that the definition refers to assets which the bond issuer “will acquire for the purpose of declaring a trust in favour of the bond holder” as the trust is integral to the nature of sukuk.

Our view

2.10 We agree that sukuk are not always based on a physical or tangible asset. We believe that the reference to asset or class of assets is not as restrictive as many respondents envisaged. The assets or class of assets which the bond-issuer acquires need not be restricted to physical or tangible assets, but includes any asset acquired for the purpose of ‘generating incomes or gains directly or indirectly’. This could cover contractual rights or other non-tangible but identifiable assets used to provide an ownership interest in the sukuk. Consequently we do not intend to amend provision 77A(2)(b), nor do we intend to add the phrase “declaration of trust” as this is included in the interpretive provision (77A(3)(c)) of the instrument.

Specification of bond term

2.11 A majority of respondents suggested that the ‘specification of a bond term’ was unduly restrictive and discriminatory, as this would render perpetual or undated sukuk as being outside of the scope of the legislation. This was felt to be inappropriate as these types of sukuk are commonly used (similar to the existence of undated instruments in the conventional bond market).

¹⁰ As in Section 48A of the Finance Act 2005.

Our view

2.12 It was not our intention to exclude perpetual or undated sukuk. We agree that AFIBs that are perpetual or undated should be permissible under the definition and have reflected this within the redrafted legislation. As suggested by one respondent, instead of amending 77A(2)(c) to reflect this, we have added an interpretive provision 77A(3)(d) stating that a sukuk that is terminable at the option of the bond issuer falls within article 77A(2)(c) even if there is no fixed repayment date.

Redemption payment and additional payment

2.13 Some respondents suggested that the use of the word 'repayment' may be construed as implying the need for a debt claim that must be repaid, which is not always the case with sukuk. Another respondent suggested that a term such as "return of capital" would be more appropriate.

Our view

2.14 We believe the inclusion of "redemption payment" is necessary to ensure that the regulatory framework covers debt-like structures. However the interpretive provision 77A(3)(h) allows for the redemption to not equal the capital amount originally paid. The terms 'redemption payment' and 'return of capital' are similar and we believe replacing the former with the latter would change the intended effect.

2.15 Some respondents indicated that in a sukuk structure the 'originator' is not necessarily the 'issuer', as the issuer is usually a special purpose vehicle (SPV). These structures generally involve the originator making a repayment of capital to the issuer who holds the assets in trust for AFIB holders and makes payments to trust certificate holders. We consider that the term 'bond issuer' is relevant in this context as the payment is made by the issuer even though the original source of the cash may be the originator. We do not believe that it is necessary to define the terms 'bond issuer' and 'originator' in the legislation, but would appreciate views to the contrary.

Reasonable commercial rate of return clause

2.16 A large proportion of respondents believed this provision would be restrictive and possibly discriminated against complex sukuk structures (for example where a return is linked to an underlying index or equity). Others indicated that returns on conventional debt securities can vary significantly from returns on a loan, even if the loan was of the same amount and to the same borrower. Furthermore, many felt the application of the rule could be problematic as it would be difficult to predict the regulator's interpretation of the provision (especially in the context of day-to-day changes in market conditions). Other respondents felt the exclusion of arrangements where the returns are linked to the profits of a business, and are in economic terms more like CIS, could be achieved by a specific exclusion of such instruments from the proposed definition.

Our view

2.17 We acknowledge the aforementioned concerns, however we consider this clause necessary as it seeks to ensure only instruments that display the characteristics of debt security can be AFIBs. As with any financial instrument the 'reasonable commercial rate of return' is not itself inflexible and can vary depending on the issuer, value, duration and other economic circumstances prevalent at the time of issue. Further guidance on this clause is published in the FSA's Perimeter Guidance (PERG) which is set out in the FSA's Quarterly Consultation Paper (6 October 2009) available at www.fsa.gov.uk.

2.18 This clause will help to ensure structures that are economically equivalent to partnership or conventional CIS are excluded from the definition of the AFIB. We believe that the alternative suggestion of an explicit exclusion of CIS-like instruments may inadvertently open up the exclusion beyond what is desirable and create a loophole within the CIS rules.

Security transferability

2.19 One respondent suggested there was an inconsistency between the CP and the proposed statutory instrument. The CP stated that the bond-holder is able to 'transfer the rights' under the arrangements to another person (who thereby becomes the bond-holder) but this was not reflected in the draft article 77A. Other respondents suggested that while not an inherent feature of an article 77 investment, the bond-holders' right of transfer could be a helpful addition to the definition. It was also suggested that the inclusion of a transferability right would not adversely limit the sukuk market and that this is a feature that might help distinguish between AFIBs and CIS. One respondent commented that it was important that the legislation reflected the right for AFIBs to be held by multiple bond-holders, in a similar fashion to conventional instruments that are sold to multiple parties. A further respondent suggested that the transferability requirement is not relevant in the context of conventional bonds and should not be included.

Our view

2.20 We agree that AFIBs should have the right to be transferred to other parties, but we do not believe that an explicit clause in article 77A is required to permit this. We believe the MiFID definition of transferable securities- which refers to "those classes of securities which are negotiable on the capital market such as shares, securities equivalent to shares, bonds or other forms of securitised debt" - already captures sukuk and therefore there is no need to have an explicit provision within the legislation¹¹

Question 4: Do you believe there are any additional provisions that should be included for the regulatory definition of an AFIB?

2.21 There was a general consensus that there were no additional provisions required to define an AFIB for regulatory purposes. One respondent did however note that although conventional bonds issued by sovereigns are dealt with separately from other conventional bonds, the same distinction has not been followed through for sukuk.

Our view

2.22 We do not intend to include any additional provisions in the legislation in relation to the definition of an AFIB, other than those discussed in this document. However, based on comments from some respondents we have decided to preserve the distinction between public and non-public financial instruments as is the case with conventional debt securities. Accordingly, we have amended draft article 77A(1) and article 78(2) of the RAO to achieve this. Note article 78(3) ensures that the definition of public securities in article 78 captures the kind of private securities covered by new article 77A, except that public securities do not have to meet the listing provisions set out in article 77A(2)(f). This amendment will ensure that public debt of any sort, including AFIBs issued by the UK or by other governments, will fall into article 78.

2.23 We have also sought to make articles 77 and 77A mutually exclusive by including an amendment to article 77(1) and we have added article 77(2)(e) to ensure that AFIBs do not fall within article 77 by simply not adhering to the commercial rate of return or mandatory listing

¹¹ The FSA's October 2009 quarterly CP adds article 77A instruments to the list of transferable securities under MiFID

provision. We would be particularly interested in your views on amendments to draft article 77A(1), and articles 77 and 78 as we have not previously consulted on these changes.

Question 5. Do you believe that the mandatory listing requirement is relevant for the reasons stated above?

2.24 Most respondents believed this provision was discriminatory as no such requirement exists for conventional debt. Some respondents did indicate this provision may not be as burdensome as perceived, as listing on a recognised stock exchange was pre-requisite to qualify for tax treatment of sukuk¹². Others agreed that this provision would enhance transparency in the market and minimise the risk of regulatory arbitrage; they were also reassured that HM Treasury intend to review the proposed rules in two years' time to ensure the regime is functioning as intended. Responses covered a range of specific issues:

- Treatment of AFIBs relative to conventional debt securities;
- Listing requirements for tax purposes;
- Risks of regulatory arbitrage;
- Listing required on a Recognised Investment Exchange or Recognised Stock Exchange; and
- Impact on secondary markets.

2.25 Treatment of AFIBs relative to conventional debt securities: Respondents suggested that article 77A(2)(f) is discriminatory and unduly burdensome as conventional bonds are not subject to a mandatory listing in order to qualify as a 'specified investment' under the RAO.

2.26 Listing required for tax purposes: Although mandatory listing is required to qualifying for beneficial tax treatment, most respondents felt that regulatory issues (such as determining the perimeter and the scope of authorised firms' permissions) need to be considered independently from tax law.

2.27 One respondent noted that in spite of the mandatory listing requirement under tax rules not all sukuk issuers will necessarily seek a listing as the tax provisions cover both the issuer and the holders and is not relevant for non-UK incorporated issuers.

2.28 Risk of regulatory arbitrage: Some respondents were unclear about the reasons set out to justify the inclusion of this clause i.e. listing would enhance the level of transparency in the market and would limit the risk of regulatory arbitrage.

2.29 Listing required on a Recognised Investment Exchange or Recognised Stock Exchange: Some respondents queried whether restricting listing to a recognised investment exchange would be too narrow a requirement. Some indicated that the concept of an RIE (s.285 FSMA 2000) was a narrower definition than a "recognised stock exchange" (used in the tax provisions).

2.30 Impact on secondary markets: Some respondents asked if there was a distinction being made between sukuk being 'underwritten' and 'arranged' in the UK and 'dealing' and 'advising' on sukuk issued and listed outside of the UK.

Our view

2.31 We believe the mandatory listing provision is necessary to limit the risk that the legislative changes could lead to regulatory arbitrage (i.e. the risk that the exclusion from being classified

¹² As included within the definition in FA 2005 s48A paragraph 1(h).

as a CIS is exploited by instruments not intended to be excluded). Avoiding these regulations would be inappropriate and could lead to consumer detriment. We acknowledge that the risk of regulatory arbitrage may be low, but nevertheless exposing consumers to inappropriate risks must be avoided.

2.32 Given that the tax regime also requires a listing, the additional burden for issuers may not be as great as envisaged. We have decided to widen the scope of provision to include an 'official stock exchange listing', trading on a 'regulated market' or any 'recognised investment exchange'. This is wider than the tax definition and also does not discriminate against issuance within the EEA, which fits within the broader objective of the European Union's Financial Services Action Plan (FSAP)¹³ of creating a single European market.

2.33 We do not envisage these regulatory changes affecting the functioning of the secondary market as non-EEA issued sukuk will be treated as they are currently treated and firms advising or dealing with EEA-issued sukuk will have their regulatory permissions automatically extended. We will review the regime after a period of 2 years to ensure the rules are functioning as intended.

Question 6: Do you agree that, although the regulatory definition of an AFIB should generally be the same as the definition of AFIBs for tax purposes and as set out in section 48A of the Finance Act 2005, it is not appropriate simply to cross-refer to section 48A?

2.34 Most respondents agreed that although the definition should be consistent, simply cross-referring the tax definition is inappropriate as not all tax provisions are relevant in the regulatory context.

Our view

2.35 Although we agree that the regulatory definition should be consistent with the tax definition we do not think it is appropriate to use the tax definition¹⁴ for regulatory purposes. The regulatory definition is more flexible and ensures that the regulatory regime is not unintentionally affected by changes to or interpretations of tax legislation

¹³ The FSAP is available at http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm

¹⁴ i.e. simply to cross-refer to section 48A of the Finance Act 2005.

