

ISDA comments on draft Prospectus SI

ISDA has reviewed the Government's proposed draft Prospectus SI¹ and we are concerned with the proposed amendments to the scope of the UK prospectus regime and in particular the proposed definition of "relevant securities" and the expansion of the regime to cover those "relevant securities".

Relevant securities

Under the proposed definition, "relevant securities" would cover:

- a) Transferable securities, other than excluded securities;
- b) Any of the investments specified in paragraph 2 other than transferable securities, excluded securities or anything excluded by paragraph 3, or
- c) Any of the investments specified in paragraph 4 other than transferable securities, excluded securities or anything excluded by paragraph 5.

The investments specified in paragraph 2 include instruments within the scope of Article 77(1) of the Regulated Activities Order (including debentures and bonds), but also include broadly defined "investments" that may include instruments not currently considered to be "securities", including:

- (b) any other investment that consists of a right to receive payment of principal or interest on indebtedness incurred for borrowed money (whether or not there is an instrument creating or acknowledging the indebtedness); and
- (e) any right to or interest in, or option to acquire or dispose of, anything falling within sub-paragraph (a), (b) or (c), including a certificate of deposit representing any such right or interest, or beneficial interests under a trust or the equivalent under the law of a country or territory outside the UK.

The inclusion of instruments within the scope of Article 77(1) of the Regulated Activities Order would already expand the scope of prospectus requirements as compared to the current position because investments can fall within Article 77 even if they are expressed not to be transferable. As a result, this would close the minibond loophole which relied on the fact that minibonds are not 'transferable securities' (because they are not transferable) but are not 'deposits' because the money borrowed is in consideration of the issue of Article 77 instruments that exceed one year in maturity.

However, while Article 77 instruments may not always be transferable, they are at least considered to be securities. This is not the case for the additional categories of investment that the Prospectus SI proposes to bring within scope of the prospectus regime.

¹

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1122741/Draft_SI_Admissions_to_Trading_and_Public_Offer_Regime.pdf

We also note the statement in the Policy Note² accompanying the Prospectus SI, that the definition of "relevant securities" intends to capture 'minibonds' and other non-transferable securities that may cause harm to investors if their offer is not subject to greater regulation. The government is keen to ensure that business that does not affect retail investors or is already regulated elsewhere is not unintentionally brought within scope of the reformed regime. The OTC derivatives markets are primarily wholesale markets and are already subject to extensive regulation. In light of this, we understand that the intention was not to bring OTC derivatives within the scope of the reformed regime.

Potential impact for OTC derivatives

Although it is established that OTC derivatives will not fall within Article 77 of the Regulated Activities Order, they could still qualify as "relevant securities" under a number of limbs of regulation 4, including either regulation 4(2)(b) or (e) of the draft Prospectus SI.

Regulation 4(2)(b) covers:

any other investment that consists of a right to receive payment of principal or interest on indebtedness incurred for borrowed money (whether or not there is an instrument creating or acknowledging the indebtedness),

While this provision would clearly cover any form of loan agreement (as well as deposits), it may also capture certain OTC derivatives.

Regulation 4(2)(e) covers:

any right to or interest in, or option to acquire or dispose of, anything falling within subparagraph (a), (b) or (c)

This provision would more obviously capture OTC derivatives, particularly options on transferable securities and other investments.

There are also other provisions under regulation 4 which could potentially capture OTC derivatives (in addition to other agreements not currently considered to be "securities").

Potential impact for collateral arrangements under OTC derivatives

It is also possible that the expanded regime would capture interests under a collateral arrangement (e.g., where securities or loans form part of a collateral pool).

Concerns with capturing OTC derivatives within the prospectus regime

We have three main concerns with potentially capturing OTC derivatives within the prospectus regime:

- **The obligations under the prospectus regime are not designed for or appropriate for bilaterally (or multilaterally) negotiated agreements.** The key obligations under the prospectus regime (including the obligation to produce a prospectus) apply to the "issuer" of relevant securities, defined as "the person who is issuing, proposes to issue or has issued the securities in question". It is unclear how this would be applied in the context of an OTC derivative, and which counterparty to a derivative would be considered to be the "issuer" (or whether both parties might be considered to be the issuer). A similar point applies to other

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https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1123008/Policy_Note_Admissions_to_Trading_and_Public_Offer_Regime_Illustrative_Statutory_Instrument.pdf

concepts used in the Prospectus SI. For example, would an OTC derivative contract be "offered in the United Kingdom" where the counterparty treated as the issuer is located in the UK, or where the other counterparty is located in the UK, or both? And although the definition of an offer to the public is broad enough to capture communication of information about any financial investment, it is unclear in practice in what sense a company negotiating an OTC derivative contract would be offering anything to the public.

- **It is not clear how the exemptions from the prospectus regime would apply in the case of bilaterally negotiated agreements.** If OTC derivatives are considered to be "securities" for the purposes of the prospectus regime, it should be possible to bring them within the scope of one of the exemptions from the prohibition on public offers, on the basis that the "offer" for each derivative contract would typically be made only to the counterparty, so by definition an OTC derivative would be "offered" to fewer than 150 persons in the UK. However, this only works on the understanding that an OTC derivative contract is a single, distinct negotiated agreement. If the view is taken that OTC derivatives with common features (but different counterparties) are to be treated as the same "security" then it will become difficult to apply not just this exemption but also the other potential exemptions under the Prospectus SI. This is one potential impact of the development of an ISIN for derivatives contracts. For example, how would counterparties assess the "total consideration" for a particular type of OTC derivative contract, or determine whether that type of OTC derivative contract has already been addressed to 150 or more persons in the UK? And what would be considered to be a "unit" for the purposes of determining whether the denomination per unit is at least GBP 50,000?
- **Possible read-across to other securities regimes.** If OTC derivatives are identified as "securities" for the purposes of the prospectus regime, this may impact the interpretation of other regimes that apply to "securities" with potentially unintended and negative consequences for the OTC derivatives markets.

Potential solutions

While we understand that HM Treasury considers that the impact of including OTC derivatives as "relevant securities" is mitigated by the availability of exemptions, as discussed above we are concerned that this does not fully address the potential difficulties. As a result, we would ask HM Treasury to consider amending the SI to ensure that the scope is limited to instruments that are currently considered to be "securities", or at least to ensure that OTC derivatives are expressly excluded.

One option for aligning the proposed SI with the existing understanding of what constitutes a "security" under English law would be to use the definition of "security" under the Regulated Activities Order³ instead of the current proposed definition of "relevant security". This should ensure that a wider range of securities than just transferable securities are brought within the scope of the prospectus regime, while also ensuring that the regime remains consistent with existing UK regulatory concepts and also that it only captures instruments for which it is actually possible to comply with the prospectus regime (rather than relying on exemptions to reduce the scope of the regime). However, it would be necessary

³ The definition of "security" is set out in Article 3 of the Regulated Activities Order, and is defined as (except where the context otherwise requires) any investment of the kind specified by any of Articles 76 to 82 [or by article 82B] or, so far as relevant to any such investment, article 89.

to consider carefully which instruments would be caught by this expanded regime and consider whether it is appropriate to apply the prospectus regime to those instruments. This is particularly the case because there may be instruments which could currently fall within the scope of both the definition of "security" and other provisions of the Regulated Activities Order. It may be necessary to clarify the precise scope of which instruments fall within the definition of "security", to the extent that this is not currently clear (or is not material for the purposes of the Regulated Activities Order).

An alternative approach would be to include OTC derivatives as "excluded securities" under regulation 5 of the proposed SI. However, this approach would not address the broader issues with the definition of "relevant security" and (depending on the definition of OTC derivatives used) would also potentially raise additional questions about the scope of the regime (e.g., would instruments that are not "OTC derivatives" under the UK EMIR definition, or that are not futures, options or contracts for differences under the Regulated Activities Order, still potentially be subject to the prospectus regime)?

We would be happy to discuss alternative solutions with you, but our strong preference would be for a solution that clearly limits the scope of the prospectus regime to "securities" in line with an existing definition of that term.

Given the potentially significant consequences for the UK OTC derivatives market of inclusion of OTC derivatives in the prospectus regime, we would be very happy to discuss the points raised above as well as any other questions or comments you may have.