Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

5 Questions About Britain's Minibond Regulatory Scandal

By **Richard Crump**

Law360, London (August 22, 2019, 5:35 PM BST) -- The collapse of minibond provider London Capital & Finance PLC, which left thousands of investors facing huge losses, has put Britain's financial watchdog in the spotlight over its worst failure as a regulator in recent years.

The Financial Conduct Authority is in the spotlight over its regulation of a minibonds provider that has collapsed, leaving investors facing losses on £236 million ($290 million) of their money. (AP)

The story was still unfolding on Wednesday when the Financial Conduct Authority confirmed that Blackmore Bond, another minibond company linked to LC&F, had closed to new investors after the regulator intervened.

Minibonds have come under closer scrutiny following the collapse of Asset Life, a provider that fell into administration in July after raising more than £8 million ($9.8 million) from investors.

The episodes show how high-risk, unregulated securities can slip through regulatory safety nets, despite early questions over loopholes and the professional standards of the companies issuing them. As the inquiries pile up, legal experts predict the FCA could get new powers over securities marketing.

Here, Law360 looks at the U.K.'s minibond scandal and the regulatory response.

What happened and why is it so controversial?

LC&F is the biggest investment scheme of its kind to collapse, leaving approximately 11,600 savers facing estimated losses of 80% on £236 million ($290 million) of minibonds.

The collapse is being investigated by the Serious Fraud Office, but the scandal has also sharpened the focus on the market machinery behind minibonds, which typically offer eye-catching rates of return.

There is no legal definition of a minibond, but the term typically refers to illiquid debt securities marketed to retail investors. A minibond is essentially an IOU issued to an investor in exchange for a fixed rate of interest. Investors are meant to get their money back at the end of a fixed period.

Minibonds have become popular in recent years among investors seeking higher returns than traditional savings while still avoiding stock market risks and volatility. The return on their money depends on the success of the company that issued the bond, and whether it is properly run. Investors may get nothing back if the business fails.

But the product has been pushed to retail investors through online comparison websites, alongside regular savings products — even though it is better suited to sophisticated investors who understand the risk involved.

“Customers are arguing that they believed the minibonds were FCA-authorized when they were not. Consequently, their impression was that the investments were safer than they actually were,” Ian Hargreaves, a partner at Covington & Burling LLP, said.

LC&F advertised returns of 8% to clients — many of them first-time investors — in products described as regulated, tax-free savings account, known as ISAs. But, in reality, investors' cash was going into minibonds, which are unlisted and difficult to convert into cash.

The firm was authorized by the FCA. But its core activity of issuing high-risk minibonds to retail investors in Britain is not a regulated activity. This left consumers without the protection of the Financial Services Compensation Scheme, which refunds investors up to £85,000 if the firm that holds their savings goes bust.

“It’s one of those perfect storms. They were marketed to retail investors as offering high yields at a time when people are struggling to get returns with interest rates so depressed,” Stephen Elam, partner at Cooke Young & Keidan LLP, said. “They were sold as compliance ISAs in certain cases, when they might not have been.”

Elam said LC&F was a crisis “waiting to happen” because of the number of smaller failures involving energy-related minibonds in recent years, which did not gain the same attention.

Diamond Global Trading and Investments, a wind turbine investment scheme, went into administration last year owing investors more than £3 million without any turbines apparently having been built. And hundreds of investors lost money in 2015 when a company called Secured Energy Bonds went into administration after selling minibonds through FCA-regulated Independent Portfolio Managers.

“They are high-risk investments. You are lending money to individual companies that are essentially in growth mode,” Elam said. “Something like LC&F has been waiting to happen for a while.”

Who is being investigated?

The FCA suspended LC&F in January, before it collapsed, for violating rules on marketing materials. It ordered the company to stop marketing its fixed-rate investment bonds and individual savings accounts.

The City watchdog launched a probe and referred the investigation to the National Economic Crime Centre, which coordinates the U.K.’s response to economic crime, amid concerns that LC&F's marketing material was “misleading, not fair and unclear.”

Syedur Rahman, legal director at Rahman Ravelli Solicitors, said there is "very stringent legislation which surrounds financial promotion.”

Under U.K. law, any marketing material that is used to either invite or induce an individual to engage in investment activity constitutes a financial promotion.

“Marketing material needs to be clear, presentable, fair and — most importantly — not misleading. The nature of the investment and the legal structure of it should be carefully considered,” Rahman said. “While issuing minibonds is not a regulated activity, financial promotions will need to be approved by an FCA-authorized person.”

LC&F’s administrator, Smith and Williamson LLP, said in March that it had uncovered “highly suspicious transactions” and that large amounts of investors' money may have ended up in the pockets of the firm's senior staff.

The administrators' investigation revealed that the firm had lent to companies including a holiday park in Cornwall, a property business in the Dominican Republic and an equestrian company. Approximately £58 million went to Surge Financial as a commission for marketing the bonds.

The report was published days after the SFO opened a criminal investigation into LC&F. The white-collar crime agency has arrested five people associated with the business, including chief executive Andy Thomson, former director Simon Hume-Kendall and Paul Careless, the boss of Surge Financial.

All five individuals have been released without charges pending further investigation.

Where were the regulators?

The FCA has been heavily criticized for failing to warn investors before the firm's demise and, under pressure from lawmakers, is facing an investigation into whether it adequately supervise the company.

Veteran barrister Elizabeth Gloster QC is looking into the FCA's handling of LC&F to assess whether the watchdog adequately supervised the company. It is only the second time the FCA has been investigated in this way.

The watchdog has acknowledged that “significant questions” need answering in the wake of LC&F's collapse over regulation of the sale and marketing of minibonds.

The investigation will establish what happened to the minibond firm and whether the FCA acted appropriately. One key fact, according to Covington's Hargreaves, is that the FCA was allegedly “given multiple warnings about mini-bonds, but did not act until December.” There were warnings as early as late 2015.

Financial adviser Neil Liversidge was approached by a client who was considering investing £60,000 in the LC&F bonds. But, after reviewing the bonds, Liversidge warned his client against the investment and told the FCA about his concerns.

Liversidge told the FCA, in a letter dated November 2015, that the promoters of the bonds were "unprofessional" and that the bonds themselves were "unsuitable."

“This should be considered one of the worst failures as a regulator in recent years,” Rahman said. “A significant amount of investor funds went into the bonds offered and it is right that there should be an independent investigation.”

Why weren’t LC&F's products regulated?

Speaking at the FCA’s annual meeting in July, Chief Executive Andrew Bailey said that one of the biggest problems facing the agency is the gap between what is regulated and what is not.

The FCA's so-called regulatory perimeter determines which type of businesses must be authorized and dictates the level of protection that financial providers must give their customers. The influential parliamentary Treasury committee has warned that the watchdog’s existing perimeter creates "grey areas" that can allow some companies to avoid supervision, making consumers believe it is safe to invest in unregulated activities.

“Essentially, the FCA regulates by activity not by organization,” said Hargreaves. “While an organization might technically be classified as a regulated entity, that does not necessarily mean that all of its activities are regulated.”

LC&F was regulated by the FCA from June 2016. However that extended only to the promotion side of LC&F's business, not the actual issuing of investments. As a result, only the promotion of the bonds needed to be in line with the FCA's rules: fair, clear, and not misleading.

Elam, of Cooke Young & Keidan, said this goes to the heart of the problem.

“You have a legal framework where ultimately what is and what isn’t regulated is very piecemeal,” he said. “While that structure shouldn’t be torn up, it does create anomalies … where some activities are regulated and some are not.”

How could regulation will be reformed?

HM Treasury will also review how minibonds and other securities and affect the economy, as well as the regulatory framework governing the investments. That could mean financial promotions will become a regulated activity. Hargreaves expects the review to be wide-ranging, looking more broadly at non-transferable securities such as government savings bonds.

The existing system of regulation relies on an informal relationship between the Treasury and the FCA as they consider whether the perimeter lies in the correct place.

But lawmakers have said this ad-hoc system is insufficient. They have said that government should hand the FCA formal powers to allow it to approach the Treasury and "formally recommend" changes to the limit of what it can regulate.

The Treasury committee recommended that regulated companies engaging in unregulated activities should give consumers clear warnings, or face fines. The regulator should also get the power to gather information about unregulated products and highlight the risks to consumers.

Hargreaves said that, at the very least, the Treasury should recommend measures to make the parameters of FCA authorization clearer to unsophisticated investors.

“In light of what has happened … the Treasury should recommend that such securities, particularly minibonds, should now fall within the remit of FCA regulation,” he said. “Even if minibonds continue to be unregulated, it is critical that customers understand the level of risk they are exposing themselves to.”

--Additional reporting by Najiyya Budaly and Joanne Faulkner. Editing by Ed Harris.