

**ALTERNATIVE FINANCE INVESTMENT BONDS (CONSEQUENTIAL
AMENDMENTS) INSTRUMENT 2010**

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.
- B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Financial Services and Markets Act 2000.

Commencement

- C. This instrument comes into force on 26 February 2010.

Amendments to the Handbook

- D. The modules of the FSA's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2) below.

(1)	(2)
Glossary of definitions	Annex A
Collective Investment Schemes sourcebook (COLL)	Annex B
Listing Rules sourcebook (LR)	Annex C

Amendments to material outside the Handbook

- E. The Perimeter Guidance manual (PERG) is amended in accordance with Annex D to this instrument.

Citation

- F. This instrument may be cited as the Alternative Finance Investment Bonds (Consequential Amendments) Instrument 2010.

By order of the Board
25 February 2010

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definition in the appropriate alphabetical position. The text is not underlined.

alternative debenture the *investment* specified in article 77A of the *Regulated Activities Order* (Alternative finance investment bonds).

Amend the following definitions as shown.

certificate representing certain securities the *investment* specified in article 80 of the *Regulated Activities Order* (Certificates representing certain securities), which is in summary: a certificate or other instrument which confers contractual or property rights (other than rights consisting of *options*):

- (a) in respect of any *share, debenture, alternative debenture, government and public security or warrant* held by a *person* other than the *person* on whom the rights are conferred by the certificate or instrument; and

...

certificate representing debt securities (in *LR*) a *certificate representing certain securities* where the certificate or other instrument confers rights in respect of *debentures, alternative debentures, or government and public securities*.

collateral

...

- (2) (in *COBS* and *CASS*) any of the following:
- (a) an *investment* specified in articles 76 to 81 of the *Regulated Activities Order*, that is:
- (i) *shares* (article 76);
- (ii) *debentures* (article 77);
- (iii) an *alternative debenture* (article 77A);

...

...

...

- debt security*
- (1) (in *DTR 2, DTR 3* and *LR*) ~~debentures~~ *debentures, alternative debentures*, debenture stock, loan stock, bonds, certificates of deposit or any other instrument creating or acknowledging indebtedness.
- ...
- (3) (except in *DTR* and *LR*) any of the following:
- (a) a *debenture*;
- (aa) an *alternative debenture*;
- ...
- designated investment*
- a *security* or a contractually-based investment (other than a *funeral plan contract* and a right to or interest in a funeral plan contract), that is, any of the following *investments*, specified in Part III of the *Regulated Activities Order* (Specified Investments), and a *long-term care insurance contract* which is a *pure protection contract*:
- (a) *life policy* (subset of article 75 (Contracts of insurance));
- (b) *share* (article 76);
- (c) *debenture* (article 77);
- (ca) *alternative debenture* (article 77A);
- ...
- inter-professional investment*
- any of the following *investments* specified in Part III of the *Regulated Activities Order* (~~Specified investments~~ Investments) or, in the case of *units* in an *exchange traded fund*, defined in the *Glossary*:
- (a) *share* (article 76);
- (b) *debenture* (article 77);
- (ba) *alternative debenture* (article 77A);
- ...
- security*
- (1) (except in *LR*) (in accordance with article 3(1) of the *Regulated Activities Order* (Interpretation)) any of the following *investments* specified in that Order:
- (a) *share* (article 76);
- (b) *debenture* (article 77);

(ba) alternative debenture (article 77A);

...

...

specified investment

any of the following *investments* specified in Part III of the *Regulated Activities Order* (Specified Investments):

...

and then further sub-divided into *classes* of *contract of insurance*;

(c) *share* (article 76);

(d) *debenture* (article 77);

(da) alternative debenture (article 77A);

...

warrant

(1) (except in *COLL*) the *investment*, specified in article 79 of the *Regulated Activities Order* (Instruments giving entitlements to investments), which is in summary: a warrant or other instrument entitling the holder to subscribe for a *share*, *debenture*, alternative debenture or *government and public security*.

...

Annex B**Amendments to the Collective Investment Schemes sourcebook (COLL)**

In this Annex, underlining indicates new text.

- 5.2.7 R (1) *A transferable security is an investment which is any of the following:*
- (a) *a share;*
 - (b) *a debenture;*
 - (ba) *an alternative debenture;*
- ...
- ...

Annex C

Amendments to the Listing Rules sourcebook (LR)

In this Annex, underlining indicates new text and striking through indicates deleted text.

Appendix 1

1.1

Relevant definitions

certificate representing certain securities

the *investment* specified in article 80 of the *Regulated Activities Order* (Certificates representing certain securities), which is in summary: a certificate or other instrument which confers contractual or property rights (other than rights consisting of *options*):

- (a) in respect of any *share, debenture, alternative debenture, government and public security or warrant* held by a *person* other than the *person* on whom the rights are conferred by the certificate or instrument; and

...

certificate representing debt securities

a *certificate representing certain securities* where the certificate or other instrument confers rights in respect of *debentures, alternative debentures, or government and public securities*.

debt security

~~debentures~~ *debentures, alternative debentures, debenture stock, loan stock, bonds, certificates of deposit or any other instrument creating or acknowledging indebtedness.*

specified investment

any of the following *investments* specified in Part III of the *Regulated Activities Order* (Specified Investments):

...

and then further sub-divided into *classes of contract of insurance*;

- (c) *share* (article 76);
- (d) *debenture* (article 77);
- (da) *alternative debenture* (article 77A);

...

warrant

the *investment*, specified in article 79 of the *Regulated Activities Order* (Instruments giving entitlements to investments), which is in summary: a warrant or other instrument entitling the holder to subscribe for a *share, debenture, alternative debenture or government and public security*.

Annex D

Amendments to the Perimeter Guidance manual (PERG)

In this Annex, underlining indicates new text and striking through indicates deleted text.

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Debt instruments

2.6.11 G ...

Alternative finance investment bonds

2.6.11A G Alternative finance investment bonds (defined in article 77A of the Regulated Activities Order and referred to in the Handbook as alternative debentures) are a form of Sharia compliant bond (known as ‘sukuk’ in the plural or ‘sakk’ in the singular) which are intended to be regulated in an equivalent manner to conventional debt securities, where appropriate. Sukuk arrangements allow assets to be held for the benefit of investors in certificates issued by a company. The benefits may include the payment of a return that is economically equivalent to interest and redemption of the certificates out of the proceeds from the disposal of the assets. Alternative debentures are not limited to those wishing to issue Sharia compliant sukuk.

2.6.11B G The arrangements which grant rights under alternative debentures are similar to the tax definition of arrangements relating to alternative finance investment bonds at section 48A of the Finance Act 2005 (see http://opsi.gov.uk/acts/acts2007/ukpga_20070011_en_5#pt3-pb9-11g53). However the purposes of the two provisions are not the same. One of the objectives of the FSA under the Act is consumer protection. Accordingly, secondary legislation made under the Act, like article 77A of the Regulated Activities Order, is likely to be interpreted by the FSA with consumer protection in mind. This may mean that whilst the arrangements described at section 48A of the Finance Act 2005 and those described at article 77A of the Regulated Activities Order are similar, they are likely to be construed differently by the courts. PERG 2.6.11FG and PERG 2.6.11GG explain the consumer protection features in the definition of alternative debentures in more detail.

2.6.11C G The arrangements which grant rights under an alternative debenture arise where:

- (1) the arrangements provide for a person (‘the bond-holder’) to pay a sum of money (‘the capital’) to another (‘the bond-issuer’);
- (2) the arrangements identify assets, or a class of assets, which the bond-issuer will acquire for the purpose of generating income or gains directly or indirectly (‘the bond assets’);
- (3) the arrangements specify a period at the end of which they cease to

have effect ('the bond term');

- (4) the bond-issuer undertakes under the arrangements:
- (a) to make a repayment of the capital ('the redemption payment') to the bond-holder during or at the end of the bond term (whether or not in instalments); and
 - (b) to pay to the bond-holder other payments on one or more occasions during or at the end of the bond term (the 'additional payments');
- (5) the amount of the additional payments does not exceed an amount which would, at the time at which the bond is issued, be a reasonable commercial return on a loan of capital; and
- (6) the arrangements are a security admitted to:
- (a) an official list; or
 - (b) trading on a regulated market or on a recognised investment exchange.

2.6.11D G Different types of *alternative debentures* are permitted so that, for example:

- (1) the assets of the arrangement may be acquired before or after it commences;
- (2) the bond-holder may (but need not) be entitled under the arrangements to terminate them, or participate in terminating them before the end of the bond term;
- (3) the return may be fixed, floating or determined in some other way;
- (4) the amount of the redemption payment may (but need not) be subject to reduction in the event of a fall in the value of the bond assets or in the rate of income generated by them.

2.6.11E G As these arrangements might amount to a collective investment scheme (see *PERG 9.4.2GG* for a broad description) a consequential amendment to the Financial Services and Markets Act 2000 (Collective Investment Scheme) Order 2001 (SI 2001/1062) has been made so that, like conventional bonds, *alternative debentures* are excluded from the definition of collective investment scheme.

2.6.11F G The range of instruments that are caught by the *alternative debenture* definition have been tightly circumscribed to ensure that only those arrangements that grant, in substance, debt-like returns are captured. This is because arrangements giving rights under an *alternative debenture* cannot amount to a *collective investment scheme* (see *PERG 2.6.11EG*). If other types of investments were covered by the *alternative debenture* definition this could have the effect of undermining the regime for regulating

collective investment schemes, which is primarily aimed at protecting the consumer from investing in unsuitable products. For example, under section 238 of the Act (Restrictions on promotion) an authorised person cannot communicate an invitation or inducement to participate in an unregulated collective investment scheme.

2.6.11G G The condition set out at PERG 2.6.11CG(6) is also intended to protect consumers. This provides that alternative debentures must be listed on an official list or traded on a regulated market or recognised investment exchange. This is because there is a risk that alternative debentures could lead to regulatory arbitrage (i.e. the risk that the exclusion from being classified as a collective investment scheme is exploited by instruments not intended to be excluded). Mandatory listing is aimed at ensuring an enhanced level of transparency, reducing the likelihood of regulatory arbitrage.

2.6.11H G (1) The main provision within the definition of alternative debenture arrangements that seeks to ensure that only instruments that display the characteristics of a debt security can be alternative debentures is set out at PERG 2.6.11CG(5). It provides that the amount of additional payments under the arrangements must not exceed an amount which would, at the time the bond is issued, be a 'reasonable commercial return on a loan of capital'. Where the return is not fixed at the outset, it is the maximum possible amount of the additional payments that must be considered in deciding this question. The following example demonstrates how this condition should be approached.

Example

ABC Ltd is a property development company. It wishes to increase its portfolio on a short-term basis. It issues 5-year sukuk to investors and uses the proceeds to buy the head lease of a commercial property. The rental income from the lease is distributed to investors in proportion to their holdings without a cap on the level of return. After 5 years, the head lease is sold on at a profit and the proceeds shared between investors.

In this example, the investors participate directly in the success or failure of the underlying property business. The sukuk is not really in the nature of a debt instrument. It is unlikely to be an alternative debenture as:

(a) additional payments under the arrangements would exceed a reasonable commercial return on a loan of the capital.

Further, where the return is not fixed at the outset, it is the maximum possible amount of the additional payments that must be considered. Here, the issue terms of the sukuk impose no upper limit on the amount of the periodic distributions: a sukuk holder subscribing £1,000 may, in a

year, get back £200 or £2,000 or nothing depending on the rental market. The maximum potential return is clearly in excess of a reasonable commercial return on a loan of £1,000; and

(b) the arrangements have not been admitted to an official list or admitted to trading on a regulated market or recognised investment exchange (see PERG 2.6.11CG(6)).

- (2) If, in the above example, investors' returns were capped at £500 per sakk per year, then this is the amount that must be considered in deciding whether the return exceeds a reasonable commercial return on a loan, even where the amounts actually received turn out to be far lower.
- (3) In applying the "reasonable commercial return" test, the sakk should be compared to a hypothetical loan to the issuer on similar terms and carrying similar risks. For example, a conventional security convertible into shares will normally carry a lower rate of interest because the conversion right has a value. The return on an "exchangeable" or "convertible" sakk should be measured against the return on an equivalent exchangeable or convertible debt security.
- (4) The risk to investors in sukuk may vary slightly from that of a conventional bond in some instances. This may be due to the fact that sukuk holders only have recourse to the bond assets or some other structural feature which results in the risk profile being higher. In such instances it may be justifiable for the rate of return to be slightly higher than that of a conventional loan.
- (5) As with any financial instrument, the pricing of sukuk will depend on the issuer's view of the market at the time of issue and "reasonable commercial return" may vary depending on the issuer and the economic circumstances prevalent at the time of issue.

2.6.12 G Certain instruments are excluded from both ~~these~~ of the categories of specified investments referred to in PERG 2.6.11G. These include trade bills, specified banking documents (such as cheques and banknotes though not bills of exchange accepted by a banker) and *contracts of insurance*. There is a further exclusion from this category of *specified investment* dealing with public debt for National Savings deposits and products. However, for the purposes of article 78 of the Financial Services and Markets Act (Regulated Activities) Order 2001, this exclusion does not apply to instruments that meet the requirements of PERG 2.6.11CG(1) to (5).

Warrants

2.6.13 G The category of *specified investment* of instruments giving entitlements to investments (referred to in the *Handbook* as *warrants*) covers warrants and other instruments which confer an entitlement to subscribe for *shares*, *alternative debentures*, *debentures* and *government and public securities*. ...

...

2.8.4 G The *regulated activity* of *dealing in investments as principal* applies to specified transactions relating to any security or to any *contractually based investment* (apart from rights under *funeral plan contracts* or rights to or interests in such contracts). The activity is cut back by exclusions as follows:

...

(4) A *company* does not *deal* as principal by issuing its own *shares* or *share warrants* and a *person* does not *deal* as principal by issuing his own *debentures*, *alternative debentures* or *debenture warrants* or *alternative debenture warrants*.

...

2.8.6A G The exclusions in the *Regulated Activities Order* that relate to the various *arranging* activities are as follows.

...

(11) Under article 34, a *company* is not carrying on a *regulated activity* under article 25(1) or (2) of the *Regulated Activities Order* (Arranging deals in investments) by arranging for the issue of its own *shares* or *share warrants* and a *person* is not doing so by arranging for the issue of his own *debentures* or *alternative debentures* or *debenture warrants* or *alternative debenture warrants*.

...

2 Annex 2G Regulated activities and the permission regime

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5 Table

<p>Table 3 : Securities, contractually based investments and relevant investments [see notes 1 and 2 to table 3]</p>

Security (article 3(1))	Contractually based investment (article 3(1))	Relevant investments (article 3(1))
<i>share</i> (article 76) <i>debenture</i> (article 77) <u><i>alternative debenture</i></u> (article 77A) <i>government and public security</i> (article 78)
...		

...

8.14.21 G This exemption disapples the restriction in section 21 of the *Act* from *non-real time financial promotions* or *solicited real time financial promotions* which are made to a *person* who the communicator believes on reasonable grounds to be a certified high net worth individual and which relate to certain *investments*. These *investments* must be either;

- (1) *shares* in or *debentures* or *alternative debentures* of an unlisted *company*; or
- (2) *warrants*, *certificates representing certain securities*, *options*, *futures* or *contracts for differences* relating to *shares* in or *debentures* or *alternative debentures* of an unlisted *company*; or
- (3) *collective investment schemes* investing predominantly in *shares* in or *debentures* or *alternative debentures* of an unlisted *company*.

...

...

8.14.30 G Article 52 concerns *non-real time* and *solicited real time financial promotions* about offers of *shares* or *debentures* or *alternative debentures* of a *company*. The offers must be made only to or be reasonably regarded as only directed at certain *persons*. These *persons* must belong to an identified group of *persons* who, when the *financial promotion* is made, might reasonably be regarded as having an existing and common interest with each other and the *company*.

...

8.14.41 G Several exemptions, including article 43 of the *Financial Promotion Order* (Members and creditors of certain bodies corporate), apply only in relation to relevant *investments* being *shares* or *debentures* or *alternative debentures* in the *body corporate* or a member of its group, or *warrants* or

certificates representing certain securities relating to such *shares* or *debentures* or alternative debentures. In the FSA's view, an exchangeable *debt security* which is partly a *debenture* or alternative debenture and partly an *option* is a relevant *investment* for these purposes.

...

8.21.9 G A 'relevant investment' in article 43 means:

(1) *shares* or *debentures* or alternative debentures; and

...

...

8.21.12 G Article 59 imposes certain conditions:

...

(2) The inducement must not relate to any *investment* other than *shares* or *debentures* or alternative debentures issued, or to be issued, by the *company* making the *financial promotion* (or a member of its *group*) or *warrants* relating to or certificates representing such *shares* or *debentures* or alternative debentures.

...

8.21.13 G Article 67 exempts any *financial promotion* other than an *unsolicited real time financial promotion* which relates to *shares*, *debentures*, alternative debentures, *government and public securities*, *warrants* or *certificates representing certain securities* which are permitted to be traded or dealt in on a relevant market.

...

8.21.17 G ... There are two main differences between article 69 and article 59.

...

(2) The requirement in article 59 that the *financial promotion* be accompanied by accounts or a report is replaced in article 69. It is replaced by a requirement that *shares* or *debentures* or alternative debentures of the *company* or another *body corporate* in its *group* (or *warrants* relating to or certificates representing such *investments*) are permitted to be traded on a relevant market (relevant market having the same meaning as in article 67 - see *PERG 8.21.13G*).

...

8.25.1 G For the purposes of article 53 of the *Regulated Activities Order*, a *security*

or *relevant investment* is any one of the following:

- (1) *shares*;
- (2) *debentures*;
- (2A) *alternative debentures*;

...

...

8.36.4 G Table Controlled investments

1.	...
...	
4.	Instruments creating or acknowledging indebtedness (referred to in the Glossary as debentures <u>and alternative debentures</u>).
...	

...

13 Annex 2 ...

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Table 2 – MiFID financial instruments and the Part IV permission regime

MiFID financial instrument	Part IV permission category	Commentary
C1 – Transferable securities	share (article 76) debenture (article 77) <u>alternative debenture (article 77A)</u> government and public security (article 78)

C2 – Money market instruments	debenture (article 77) <u>alternative debenture</u> <u>(article 77A)</u> government and public security (article 78)
...		