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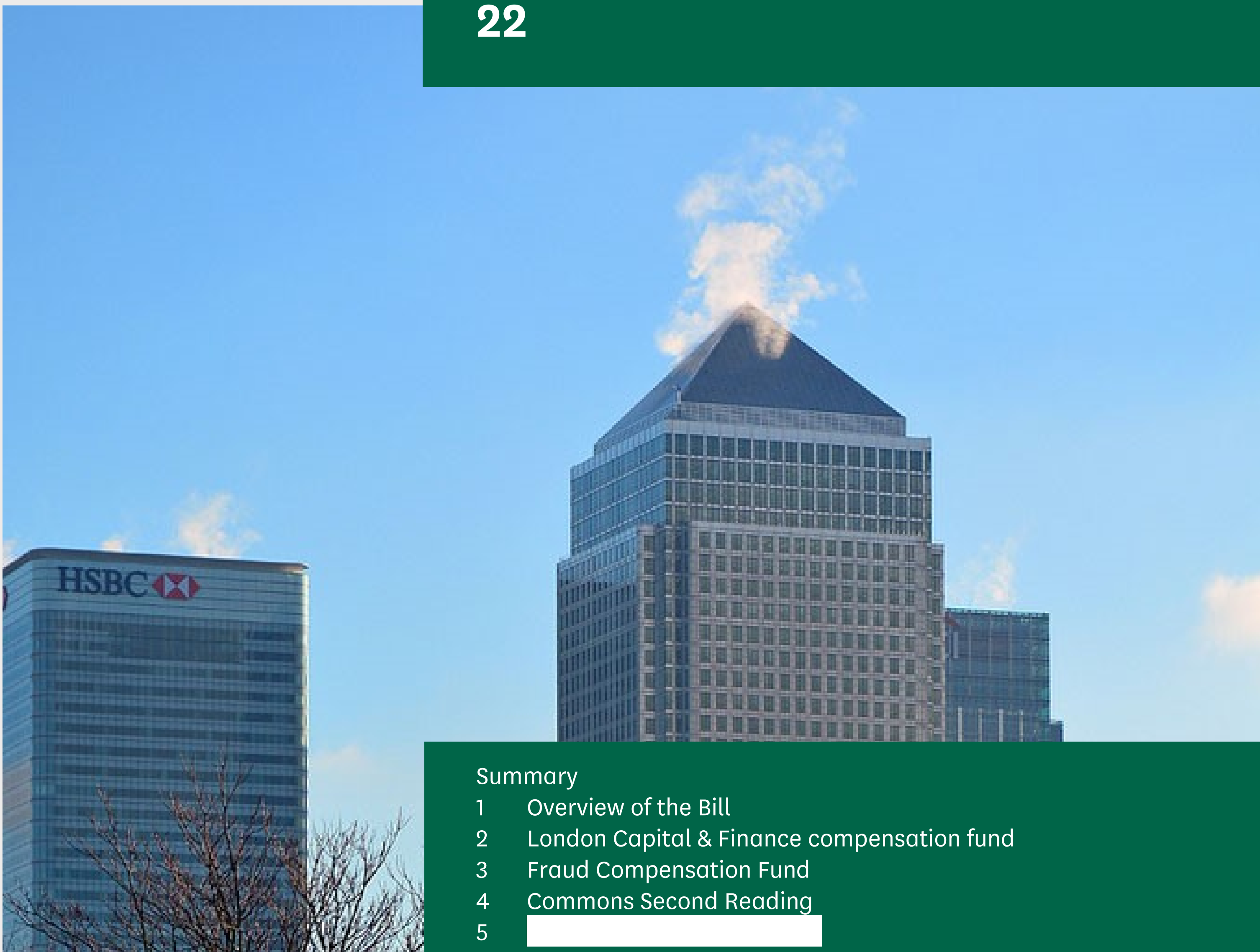
Compensation (London Capital & Finance plc and Fraud Compensation Fund) Bill 2021-22



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Summary

The Compensation (London Capital & Finance plc and Fraud Compensation Fund) Bill 9 of 2021-22 was introduced in the House of Commons on 12 May 2021. It had its Second Reading on 8 June. Public Bill Committee took place on 15 June 2021. Report Stage and Third Reading are to be on 22 September.

The Bill covers arrangements required for two discrete compensation funds.

London Capital & Finance plc compensation fund

London Capital & Finance (LC&F) was a financial services firm that failed in January 2019. While LC&F was regulated by the Financial Conduct Authority (FCA), the 'mini-bonds' it sold were not.

In March 2019, the administrators reported that 11,625 bondholders had invested over £237 million in LC&F's products. They estimated that bondholders would be likely to receive as little as 20% of their initial investment.

In addition, as the mini-bonds themselves were not regulated, the majority of bondholders were not covered by the Financial Services Compensation Scheme (FSCS). By April 2021 the FSCS had paid out £57.6m to 2,871 bondholders who held 3,900 LC&F bonds.

Dame Elizabeth Gloster's report into the FCA's regulatory supervision of LC&F was strongly critical of the regulator's actions. Although her remit explicitly excluded the question of compensation, John Glen, the Economic Secretary, announced in December 2020 that the exceptional circumstances of the case warranted the establishment of a compensation fund.

The Government said the compensation scheme would cap individual entitlements at £68,000 (80% of the £85,000 FSCS compensation limit) and estimated that the total cost of payouts would be about £120 million.

Clause 1 of the Bill would allow the Treasury to finance the compensation fund and for the Financial Services Compensation Fund to administer it.

Fraud Compensation Fund

The Fraud Compensation Fund (FCF) is a compensation scheme that can pay compensation where an occupational pension scheme has had its assets reduced as a consequence of an offence involving dishonesty and where the scheme employer is insolvent and unable to make good the shortfall caused by the offence. It was set up under the Pensions Act 2004 (PA 04) and is run by the Board of the Pension Protection Fund. It is funded by a levy on occupational pension schemes.

Historically, claims on the FCF have been low. However, in November 2020, the High Court ruled in Board of the PPF v Dalriada that "pension liberation" schemes were eligible to apply to the FCF for compensation. These are schemes that have been set up with the aim of persuading people to transfer their pension savings from legitimate schemes to fraudulent schemes with promises of high investment returns.

In years when the FCF needs increased funding, the Secretary of State may impose a fraud compensation levy on occupational pension schemes. This is subject to a statutory maximum (PA 04 s189; SI 2006/558).

The PPF has estimated that compensation payments claimed as a result of the High Court judgment, will be in the region of £350 million. At the time of the judgement, the FCF had assets of £26.2m. Even with future levy income, the expectation was that there would be unfunded liabilities in the region of £200m to £250m (Bill 9 – EN, para 8-9).

Clause 2 of the Bill would give the Secretary of State the power to make a loan to the Board of the PPF to enable the payment of compensation to eligible occupational pension schemes following the High Court in judgment. The loan would be repaid by the FCF levy over a period currently estimated to be between 10 and 15 years. The FCF levy rates and repayment period will be subject to formal consultation, timetabled for the autumn (Bill 9 – EN, para 36).

Second Reading

Second Reading took place on 8 June 2021. The Bill passed without a division.

The Government argued that the measures were required to ensure "financial protection and fair outcomes for those falling victim in these particular circumstances." Members noted the importance of trying to prevent such situations from arising in the first place.

Public Bill Committee

No amendments were made to the Bill during Public Bill Committee stage on 15 June 2021.

Members emphasised the need for culture change within the FCA. They questioned whether the LC&F case really was exceptional and sought assurances that progress in implementing the Gloster Report's recommendations would be reported.

They were also concerned about the impact of the FCF levy on two Master Trusts who in 2019 had paid 37% of the FCF levy, despite having holding only around one percent of assets in the workplace pension sector.

1 Overview of the Bill

The Compensation (London Capital & Finance plc and Fraud Compensation Fund) Bill 9 of 2021-22 was introduced in the House of Commons on 12 May 2021. Second Reading took place on 8 June 2021.

The Bill would provide the legislative framework for two discrete compensation funds:

- **Clause 1** of the Bill extends to the whole of the United Kingdom. It would make arrangements to set up a compensation scheme for customers of London Capital & Finance plc who were not eligible for redress from the Financial Services Compensation Scheme.
- The provisions in **Clause 2** are intended across the UK. Because occupational pensions are a transferred matter in Northern Ireland, a Legislative Consent Motion will be required. It would grant the Secretary of State powers to make a loan to the Board of the Pension Protection Fund for the purpose of compensation payments to eligible occupational pension schemes following the High Court case of the Board of the PPF v Dalriada ([2020] EWHC 2960 (Ch)).

The text of the Bill as published is available in standard and large-print format. Accompanying explanatory notes are also available in standard and large-print format.

As the Bill is short and covers two discrete areas, this briefing paper covers each area separately.

2 London Capital & Finance compensation fund

2.1 The collapse of London Capital & Finance

Mini-bonds are a type of illiquid investment typically sold direct to investors. Unlike corporate bonds they can't be sold on before they mature. This leads to higher levels of risk, reflected in higher interest rates. The FCA provides further background about them.

London Capital & Finance (LC&F) was a financial services firm that failed in January 2019.

Among other activities, it sold non-transferable debt securities – also known as mini-bonds – to individual investors. While the firm and many of its activities were regulated by the Financial Conduct Authority (FCA), the sale of mini-bonds was not.

LC&F went into administration on 30 January 2019, following a series of interventions by the FCA. The FCA had found LC&F's advertising to be "misleading, not fair and unclear," and so ordered the firm to withdraw all of its marketing materials on 10 December 2018. Because of "serious concerns about the way the firm was conducting its business", the FCA also ordered LC&F to cease conducting all regulated activity on 13 December 2018. [1] Among other "inappropriate or misleading representations", LC&F was marketing its 'mini-bonds' (the product it sold to investors) as eligible for inclusion in ISAs when they were not. [2]

This meant that the majority of bondholders were not eligible for compensation from the Financial Services Compensation Scheme (FSCS) when the firm collapsed. In general, that scheme provides coverage of up to £85,000 in relation to regulated products or activities. The FSCS has published information about the limited situations in which LC&F customers were eligible for compensation.

For further background please see our briefing paper London Capital & Finance.

In March 2019, the administrators reported that 11,625 bondholders had invested over £237 million in LC&F's products. They estimated that bondholders would be likely to receive as little as 20% of their initial investment. [3]

The administrators highlighted major discrepancies between the way LC&F presented itself to investors and the reality of their operations:

1 FCA, London Capital and Finance Plc enters administration, 5 November 2019
2 FCA, Second Supervisory Notice to London Capital & Finance plc, 17 January 2019
3 Smith & Williamson, London Capital & Finance Plc (in administration): Joint administrators' Report and Statement of Proposals pursuant to Paragraph 49 of Schedule B1 Insolvency Act 1986, 25 March 2019, p5

- There are concerning connections between people currently or previously involved with LCF and people currently or previously involved with the Borrowers and sub-Borrowers.

- The fact that c£236m of Bondholder monies has been lent by LCF to a small number of Borrowers and sub-Borrowers shows a lack of the spread of risk that one would expect from a professional portfolio manager. It is especially concerning that c£122m was lent to one Borrower, notwithstanding that Borrower on-lent a large proportion of that money to a number of sub-Borrowers.

- The Bondholders believed that their money was being lent to a wide portfolio of UK small and medium sized enterprises ('SMEs') but they now find that it has been lent to a small number of complex businesses with substantial risk profiles and which are often dependent on foreign and/or exotic (such as oil & gas) assets. [4]

They also noted that the bondholders were very concerned:

- that they have been characterised as sophisticated lenders when, in reality, they are often people who have invested their life savings in LCF financial products for the best possible return. The Bondholders are very upset that the boards of directors of the Borrowers and sub-Borrowers have viewed them as investors with an interest in investments with high risk profiles.

- that LCF was planning to engage in debt for equity swaps with the Borrowers and sub-Borrowers, using the monies lent by the Bondholders. The Bondholders had seen no evidence in any of the Information Memoranda indicating that Bondholder monies might be used in this way.

- that there are corporate transactions involving the Borrowers and sub-Borrowers which involve companies with similar names, frequent name and accounting date changes, Companies House strike off notices and the same individuals. [5]

There have since been a number of investigations, including by the Serious Fraud Office and the Financial Services Compensation Scheme (FSCS). The latter involved considering complex cases involving the products and advice given, as that would determine individual eligibility. On 21 April 2021 the FSCS

[4] Smith & Williamson, Update to Bondholders, 21 February 2019, p5

[5] Smith & Williamson, Update to Bondholders, 21 February 2019, p6

reported that it had paid a total of "£57.6m to 2,871 LCF bondholders who held 3,900 LCF bonds." [6] It went on to note:

> We initially thought that FSCS may not be able to pay compensation to any LCF bondholders, so we are pleased that we have been able to help some of them get their lives back on track, but understand there are many more who we haven't been able to pay. We now know that these customers will be able to receive compensation under the government's one-off scheme. [7]

2.2 The Gloster Report

One of the central features of the collapse and its consequences has been the complexity of the FCA's "regulatory perimeter", which determines the regulator's scope for action (and so in broad terms the FSCS coverage).

On 1 April 2019, further to correspondence with the Treasury Select Committee and the FCA, the Economic Secretary agreed that it was in the public interest to order the FCA to establish an independent investigation into the regulatory supervision of LC&F and the regulation of mini-bonds. [8] HM Treasury published a more detailed Direction on 23 May. The review would be led by Dame Elizabeth Gloster, a former High Court and Court of Appeal judge and international arbitrator.

The regulatory perimeter – and how it was perceived – would be a central theme in the investigation:

> The independent investigation will consider the FCA's actions, policies and approach when regulating LC&F. Alongside this, the Treasury also announced it would review the wider policy questions raised by the case of LC&F. These relate to the regulatory and tax treatment of the kinds of retail investment products issued by London Capital and Finance (often referred to as 'mini-bonds'). [9]

The investigation's website [10] includes further detail and sets out the scope and limitations, noting that it would exclude considerations of individual compensation:

> Dame Elizabeth Gloster and her team are very conscious of the considerable financial and personal impact which the events

6 Financial Services Compensation Scheme, London Capital & Finance plc (accessed 21 May 2021)
7 Ibid.
8 Letter from Economic Secretary to the Treasury to Chair of the FCA, 1 April 2019
9 Financial Conduct Authority, Independent investigation into London Capital & Finance (accessed 11 May 2021))
10 London Capital & Finance Investigation (accessed 12 May 2021)

> concerning LCF have had on many of those who placed, and lost, investments with LCF.
>
> However, as set out above, the remit of the investigation is to consider the conduct of the FCA over the period 1 April 2014 to 30 January 2019. That means that the investigation will not be in a position to determine:
>
> - Whether individual bondholders are entitled to compensation
> - The location or recoverability of any investments following the collapse of LCF
> - Whether any criminal or civil liability attaches to those involved in the events of LCF.

Dame Elizabeth's report was released on 10 December 2020. [11] It:

> 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.

The report contends that there were "significant gaps and weaknesses in the policies and practices implemented by the FCA to analyse the business activities of regulated firms." It puts them into three categories:

1. **FCA's "approach to its regulatory perimeter" was too limited:** The FCA did not encourage staff to look beyond the perimeter to consider LC&F's wider activities. Most of LC&F's revenue came from non-regulated activities, which were by their nature not scrutinised. But the fact that some activities were regulated gave a stamp of "respectability" to the firm's wider "risky, and potentially fraudulent" products, particularly for "unsophisticated" consumers.
2. **Breaches of financial promotion were dealt with in isolation:** Although the FCA had raised concerns about breaches of its financial promotion rules on six occasions, these were dealt with in isolation and did not result in wider holistic review. This meant that potential misuse of LC&F's regulated status to promote the sale of unregulated products was not considered.
3. **Lack of training:** Staff who reviewed information submitted by LC&F had not had enough training to adequately identify signals of fraud and irregularity.

[11] Elizabeth Gloster, Report of the Independent Investigation into the Financial Conduct Authority's Regulation of London Capital & Finance plc

Recommendations

The report made 13 recommendations – nine for the FCA's policies and practices, and four for the Treasury and Government regarding the wider regulatory regime. [12] In line with the original scope, the recommendations did not refer to compensation.

For the FCA

1. The FCA should direct staff responsible for authorising and supervising firms, in appropriate circumstances, to consider a firm's business holistically.

2. The FCA should ensure that its Contact Centre policies clearly state that call-handlers: (i) should refer allegations of fraud or serious irregularity to the Supervision Division, even when the allegations concern the non-regulated activities of an authorised firm; (ii) should not reassure consumers about the nonregulated activities of a firm based on its regulated status; and (iii) should not inform consumers (incorrectly) that all investments in FCA-regulated firms benefit from FSCS protection.

3. The FCA should provide appropriate training to relevant teams in the Authorisation and Supervision Divisions on how: (i) to analyse a firm's financial information to recognise circumstances suggesting fraud or other serious irregularity; and (ii) when to escalate cases to specialist teams within the FCA.

4. The senior management of the FCA should ensure that product and business model risks, which are identified in its policy statements and reviews as being current or emerging, and of sufficient seriousness to require ongoing monitoring, are communicated to and appropriately taken into account by staff involved in the day-to-day supervision and authorisation of firms.

5. The FCA should have appropriate policies in place which clearly state what steps should be taken or considered following repeat breaches by firms of the financial promotion rules.

6. The FCA should ensure that its training and culture reflect the importance of the FCA's role in combatting fraud by authorised firms.

[12] Elizabeth Gloster, Report of the Independent Investigation into the Financial Conduct Authority's Regulation of London Capital & Finance plc, p291-308 (accessed 11 May 2021)

7. The FCA should take steps to ensure that, to the fullest extent possible: (i) all information and data relevant to the supervision of a firm is available in a single electronic system such that any red flags or other key risk indicators can be easily accessed and cross-referenced; and (ii) that system uses automated methods (e.g. artificial intelligence/machine learning) to generate alerts for staff within the Supervision Division when there are red flags or other key risk indicators.

8. The FCA should take urgent steps to ensure that all key aspects of the DES Programme that relate to the supervision of flexible firms are now fully embedded and operating effectively.

9. The FCA should consider whether it can improve its use of regulated firms as a source of market intelligence. [13]

For HM Treasury and the Government

The investigation also considered how the wider regulatory regime affected the FCA's ability to supervise LC&F. It made the following wider recommendations:

10. The Treasury should consider addressing the lacuna in the allocation of ISA-related responsibilities between the FCA and HMRC.

11. The Treasury should consider whether Article 4 of MiFID II or section 85 of FSMA should be extended to non-transferable securities.

12. The Treasury should consider the optimal scope of the FCA's remit.

13. The Treasury and other relevant Government bodies should work with the FCA to ensure that the legislative framework enables the FCA to intervene promptly and effectively in the marketing and sale through technology platforms, and unregulated intermediaries, of speculative illiquid securities and similar retail products.

[13] Financial Conduct Authority, FCA responds to independent reviews into its regulation of London Capital & Finance and Connaught, 17 December 2020

2.3 Responses to the Gloster Report

Both the FCA and the Government accepted the recommendations and committed themselves to working together to implement them, as discussed below. [14]

Charles Randell, Chair of the FCA, said:

> We accept all the recommendations that have been made to the FCA and we are profoundly sorry for the mistakes we have made…
>
> The FCA has always prioritised supervising regulated activities which affect the most vulnerable in our society, who often have very limited financial choices. We also introduced measures designed to prevent harm for those consumers who had more ability to choose. These reports not only highlight operational mistakes; they also indicate that the measures we introduced may not have been as effective as we wanted and challenge the balance that we struck at that time. [15]

The Economic Secretary, John Glen, made a Written Statement in response to the report on 17 December 2020. [16] With regard to compensation, he noted three existing channels that might allow bondholders to recover funds:

- Recovery of funds via legal action by the administrators
- Eligibility for FSCS compensation relating to regulated activities
- Compensation through the FCA complaints process (which would consider "financial loss as a result of actions or inactions of the FCA"

But his response went further. In exceptional circumstances, the Government may set up its own compensation scheme, as had been the case with Equitable Life. While Mr Glen reiterated the role of regulation to try to prevent rather than to compensate for losses, he announced that the circumstances in the LC&F case were such that the Treasury would indeed establish a compensation scheme in 2021:

> The Government recognises that LCF's failure and the loss of investment has had a significant and distressing impact on LCF's bondholders. With any investment there is a risk that, sometimes, investors will lose money. The purpose of regulation is to ensure that investors have the right information to understand their risk. Within this system, even the best regulators, doing everything right, will not be able to, and should not be expected to, ensure a zero-failure

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14 HCWS678, 17 December 2020; Report of the Independent Investigation into the Financial Conduct Authority's Regulation of London Capital & Finance plc – The FCA Response, p7, para 1.1

15 Financial Conduct Authority, op. cit.

16 UIN HCWS678, 17 December 2020

> regime. And the Government cannot, and should not be expected to, step in to compensate for every failure and every loss.
>
> But it is clear in the case of LCF that there are multiple, complex reasons why people lost money. And the Government recognises that there is likely to be some variation in how much of their investment bondholders are able to recover through these processes.
>
> The Government therefore announces that, taking into consideration the specific and complex set of circumstances surrounding the collapse of LCF, the Treasury will set up a compensation scheme for LCF bondholders. The scheme will assess whether there is a justification for further one-off compensation payments in certain circumstances for some LCF bondholders.

Pat McFadden, shadow Economic Secretary, stated that it was "only right" that the Government should establish a compensation scheme, but added that the case had raised wider questions about the effectiveness of the FCA, particularly as Brexit meant that its responsibilities were about to expand.

A cross-party Early Day Motion submitted by Neale Hanvey on 24 February 2021 "welcome[d] the announcement from the Government that it will establish its own compensation scheme for LC&F bondholders; and urge[d] the Government to set out the terms of the scheme at the earliest opportunity." [17]

More widely, the BBC reported that the overall recommendations (rather than the announcement of the compensation fund) had surpassed bondholders' expectations:

> Andrea Hall, who speaks for a campaign group of hundreds of LCF Bondholders said the report revealed "gross regulatory failure" by the FCA.
>
> "The FCA threw this back in our faces. I'm ecstatic that all the hard work to prove it has been worthwhile and has been acknowledged," she said. "This review is better than we could have imagined."

Progress on implementing recommendations

The FCA has published two summary updates on progress in implementing the recommendations from the Gloster Report:

1. A letter from the Chair of the FCA to the Economic Secretary on 16 April, covering progress on the recommendations to the FCA, as well as some comments on recommendations for the Treasury.

[17] EDM 1544, 24 February 2021

2. A letter from the Chief Executive of the FCA to the Chair of the Treasury Committee on 12 May outlining further progress.

General points in these letters (and from the FCA's initial response) include:

- Further training for staff
- Reviewing 'how-to' guides in the contact centre
- Reviewing policies and guidance to enable staff to review a firm's business holistically
- Reviewing financial promotions policies
- Continuing information sharing with a range of partners including FSCS, FOS and law enforcement agencies
- Investing in and improving data capability.

The Treasury launched a consultation on the regulation of mini-bonds in April 2021. It had launched a separate and continuing consultation on the regulatory framework for approving financial promotions in July 2020.

Treasury Select Committee inquiry

The Treasury Committee's inquiry into the FCA's Regulation of London Capital & Finance plc questioned the Economic Secretary on liaison between Government departments on suitable legislative arrangements to tackle fraud in online advertising, given the absence of relevant provisions in the draft Online Safety Bill. [18]

The report from the inquiry was published on 24 June 2021. The report sought to "examine changes that have been made since the publication of Dame Elizabeth's [Gloster] report". As the Gloster report's remit did not include compensation, the focus was on its recommendations about change at the FCA and the legal framework which underpins it. The Committee report concluded that:

- **Culture**: the FCA was going through a positive transformation programme to change its culture, but should publicly set milestones and an end date.
- **Responsibility**: the FCA should have recruited more widely for its Executive Director for Transformation role, and missed an opportunity to consider fresh leadership.
- **Perimeter of regulation**: the FCA should require authorised firms to set out the risks to consumer associated with their unregulated activities. It should also set out in its annual perimeter report how its supervision policies reflect both regulated and unregulated activities of authorised

[18] Treasury Committee, Oral evidence: The Financial Conduct Authority's regulation of London Capital & Finance pls, HC 1191, 21 April 2021, Q377-381

firms, and the Treasury should publish a statement on how it will approach changes to the activities the FCA regulates.

- **Regulation of mini-bonds**: The Treasury should proceed with its analysis on whether to regulate mini-bonds and publish the outcome by the end of September 2021.
- **Financial promotions**: the FCA should be more interventionist in enforcing the financial promotions regime, and the Treasury should consider what changes need to be made to protect consumer; and
- **Online Safety Bill**: the Government should include measures to address online advertising fraud in the Online Safety Bill. The FCA should work with platforms to remove misleading or fraudulent adverts quickly.

The Treasury responded to the Committee's report on 19 August 2021. Economic Secretary John Glen noted that:

- He believed existing arrangements for examining and amending the regulatory perimeter are effective. The Government, working with the FCA, consults on any proposed changes, which are then subject to parliamentary approval.
- The Treasury intends to publish its response to the consultation on the regulation of mini-bonds and bring forward plans for legislation "in the autumn."
- The Treasury has commenced work with the FCA to review exemptions to the financial promotions regime, and is currently pursuing a change to strengthen the regime to ensure that the firms able to approve financial promotions are only those with appropriate expertise; and
- The Government is considering tougher regulation of online advertising, including proposals to tackle fraud online.

The FCA's response was dated 25 August 2021 and noted that:

- An Executive Director for Transformation was recruited from the current executive team in order to "get things moving quickly." Bonuses had been removed from individuals named as responsible for failings, but there was no personal culpability or misconduct.
- The FCA aims to have completed the measures required to meet the Gloster report's recommendations by the end of the year.
- The FCA will continue to consider whether rule changes are needed to protect consumers from getting misleading impressions about regulatory protections available to them.
- It has introduced a new holistic approach to higher-risk firms applying for FCA authorisation, that includes a more detailed review of unregulated financial activities expected to be performed.
- As at 23 August 2021, the FCA had responded to 98% of the 1,106 complaints received by it about its regulation of LC&F.
- Since October 2019 the FCA had used its powers more assertively to stop non-compliant financial promotions. The FCA shared the

Committee's concerns about the appropriateness of current exemptions to the financial promotions regime.

A Joint Committee of both Houses has been established to scrutinise the draft Online Safety Bill. It will report by 10 December 2021. It remains to be seen whether it will adopt the Committee's recommendations around online advertising fraud.

2.4 The compensation scheme

HM Treasury published an outline of the proposed compensation scheme on 12 April 2021 [19] and the Economic Secretary provided further detail in a Written Statement on 19 April. [20] The scheme would:

- be open to bondholders who had not already been compensated via the FSCS
- pay up to a maximum of £68,000 to individual investors – that is, 80% of what they would have been entitled to if they had been eligible for FSCS compensation
- expect to pay out up to £120 million within six months of the passage of necessary legislation [21]

In his statement the Economic Secretary highlighted the point that the Government considered the case to be exceptional:

> It is an important point of principle that government does not step in to pay compensation in respect of failed financial services firms that fall outside the FSCS. Doing so would create the wrong set of incentives for individuals and an unnecessary burden on the taxpayer. However, as I will set out in this statement, the situation regarding LCF is unique and exceptional. After considering the issues in detail, the government has decided to establish a compensation scheme for LCF bondholders. The scheme I am announcing today appropriately balances the interests of both bondholders and the taxpayer and will ensure that all LCF bondholders receive a fair level of compensation in respect of the financial loss they have suffered.
>
> LCF's business model was highly unusual, both in its scale and structure. In particular, it was authorised by the FCA despite generating no income from regulated activities. This allowed LCF's unregulated activity of selling mini-bonds to benefit from the 'Halo Effect' of being issued by an authorised firm, helping LCF gain

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[19] HM Treasury, Policy paper: London Capital & Finance Compensation scheme, 12 April 2021 (accessed 12 May 2021)

[20] UIN HCWS922, 19 April 2021

[21] The Economic Secretary noted that 97% of initial investments were in any event below that limit.

> respectability and grow to an unprecedented scale before it failed, resulting in losses for thousands of bondholders.
>
> A complex range of interconnected factors contributed to the scale of losses for LCF bondholders. Clearly individuals have responsibility for choosing investments that are suitable for their risk profile. The high interest rates on offer from LCF, particularly when compared to deposit accounts, should have prompted questions from potential bondholders about the risks. While some may have understood those risks and invested anyway, LCF's disclosure materials and marketing strategy may have led others to believe they were investing in a product that was far safer than it was. [22]

He went on to caution against any expectations that the Government would step in in the case of future bad investments, as that risked creating a "a moral hazard for investors and potentially lead individuals to choose unsuitable investments." He reiterated this point in a letter to the Chair of the Treasury Select Committee on 14 May, noting that "[o]nly three government compensation schemes have been established in the last three decades (for Barlow Clowes, Equitable Life and LCF)."

On 20 July 2021, the Government announced that it would legislate for the tax treatment of payments form the scheme:

> The Government will legislate in the Autumn to ensure that payments made by the London Capital & Finance Compensation Scheme will not be subject to Capital Gains Tax. This will provide certainty to bondholders that these payments will be free from income tax and Capital Gains Tax. This measure will apply retrospectively from the date payments are made. The Government will also ensure that the Compensation Scheme terms enable bondholders who receive compensation in respect of a subscription to an ISA to return the money to an ISA without it contributing to their annual subscription limit. [23]

2.5 The Bill

The first clause of the Bill would make arrangements to set up a compensation scheme for customers of London Capital & Finance plc.

Clause 1(1) would allow the Treasury to incur expenditure to provide compensation under the scheme to LC&F customers "who have been adversely affected by matters identified in the Gloster Report".

[22] UIN HCWS922, 19 April 2021

[23] UIN HCWS204, 20 July 2021

Clause 1(2) would specify that subsection 3 would apply to the scheme because the Treasury would require the Financial Services Compensation Scheme to administer the proposed scheme in line with the general arrangements set out in Part 15A of the Financial Services and Markets Act 2000.

Clause 1(3) would waive the requirement set out in section 138I of the Financial Services and Markets Act 2000 for the Financial Conduct Authority to carry out a full public consultation and impact assessment before the proposed LC&F compensation scheme is established.

Clause 1(4) specifies that references to the “Gloster Report” relate to the Independent Investigation into the Financial Conduct Authority’s Regulation of London Capital & Finance plc, as revised on 10 December 2020.

3 Fraud Compensation Fund

3.1 Background

A defined benefit (DB) scheme is one where the amount you're paid is based on how many years you worked and the salary you earned.

With a defined contribution (DC) scheme you build up a pot of money to provide an income in retirement. Unlike DB schemes, the income you might get from a DC scheme depends on factors including the amount you pay in, the fund's investment performance and the choices you make at retirement.

The Fraud Compensation Fund (FCF) pays compensation to occupational pension schemes - defined contribution (DC) and defined benefit (DB) - which have lost out financially due to dishonesty.

The FCF was set up under the Pensions Act 2004 (PA 04) (Pt 2, Ch 4) to replace the previous Pensions Compensation Board, [24] which was dissolved on 1 September 2005, with its assets and liabilities transferred to the FCF. [25] The main differences – apart from the fact that the FCF would be run by the Board of the Pension Protection Fund – was that there would be 100% compensation, rather than 90% as previously. [26]

Most occupational pension schemes are eligible for the FCF – exceptions set out in regulations include public service pension schemes and schemes with a Crown Guarantee. [27] A claim can be made if:

- The employer has suffered an insolvency event (or if the employer cannot suffer an insolvency event, it is unlikely to continue as a going concern);
- There is no likelihood of the pension scheme being rescued; and
- The value of the scheme's assets has been reduced due to an offence involving dishonesty. [28]

An application can be made by trustees, scheme managers, members and other beneficiaries, scheme administrators or representatives of the above. However, if an application is agreed, compensation is paid directly to scheme trustees or managers. [29]

In principle, it is possible pension schemes without assets and without trustees to make a claim on the FCF. However, the way the legislation is framed means a trustee needs to be in place in practice in order to progress applications and process compensation. There are a small number of schemes, that The Pensions Regulator (TPR) is aware of, without TPR or court appointed trustees. Where there may be the potential of making a FCF claim

[24] This in turn had been set up under the Pensions Act 1995, ss78-86
[25] Pensions Act 2004, Chapter 4; PPF, Annual Report 2005-06, HC 1586, para 3.6.4
[26] Pensions Act 1995, s83; Pensions Act 2004, s185
[27] Pensions Act 2004, s182; SI 2005/2184, reg 2
[28] Ibid, s182
[29] Ibid, s185

TPR is reviewing these schemes, with a view to assessing whether a TPR appointment should now be made.[30]

The rules are in Pensions Act 2004 (ch 4) and Occupational Pension Schemes (Fraud Compensation Payments and Misc. Amendments) Regulations 2005 (SI 2005/2184). There is an overview in PPF leaflet, All you need to know about the Fraud Compensation Fund.

Northern Ireland has separate but corresponding legislation in the Pensions (Northern Ireland) Order 2005 (2005/255).

Pension Protection Fund

The FCF is separate from the Pension Protection Fund, also administered by the PPF Board, which was set up under PA 04 (Pt 2, ch 3) to provide compensation to members of DB occupational pension schemes in the event that the scheme's sponsoring employer becoming insolvent and leaving the scheme with insufficient funds to pay its members' pensions. For background, see Pension Protection Fund, Commons Library Briefing Paper CBP 3917, October 2020.

3.2 FCF Compensation

Under the FCF, 100% compensation is paid (rather than the 90% that was paid under the previous Pensions Compensation Board).[31] When the 2004 Act was before Parliament, the Government said that "the simplest and fairest approach in the exceptional circumstance of theft by fraud is fully to compensate the loss, especially since such occasions are relatively rare." It said the aim of the FCF was to "restore the individual members' scheme to what it was."[32]

The amount of compensation in a particular case is, as a general rule, the difference between the value of scheme assets immediately preceding the loss and that immediately before the application date.[33] A claim on the FCF is a last resort. Trustees are expected to make every effort to recover losses from other sources: for example, by making an application to the Insolvency

30 Letter from Chief Executives of TPR and the PPF to chair of Work and Pensions Select Committee, 16 July 2021

31 Pensions Act 1995, s83; Pensions Act 2004, s185

32 HL Deb 13 September 2004 c275 GC; Pensions Bill Deb, 1 April 2004, c 603; DWP, Simplicity, security and choice: working and saving for retirement, December 2002, Cm 5677, chapter 4.5, para 84-6; Institutional Investment in the UK: A Review, Paul Myners, March 2001, para 8.25

33 Pensions Act 2004, s185; PPF leaflet, All you need to know about the Fraud Compensation Fund, p5

Service where an insolvent employer had failed to pay contributions deducted from employee wages into the scheme. [34]

3.3 The Fraud Compensation Levy

The Secretary of State may impose a fraud compensation levy on occupational pension schemes. Such a levy is only payable in years where the Fraud Compensation Fund needs increased funding and only one such levy may be imposed in any year. The Board of the Pension Protection Fund issues a notice when payment is required to increase funding. The levy is collected for the PPF Board by the Pensions Regulator. [35]

The levy is calculated according to the total number of scheme members on the last day of the scheme year before the beginning of the previous financial year. A maximum rate per member is set in regulations. [36]

Under the Pensions Compensation Board, the statutory maximum levy was set at 23p per member. This had remained unaltered since 1997. The levy had been charged only twice – in 1997 and 2005. When the regulations for the FCF levy were introduced in 2006, the Government said that the historically low call on the resources of the Pensions Compensation Board made it possible to retain 23p as the maximum rate at the time. [37]

The Government increased the maximum levy to 75p per member in 2011, saying this was necessary to ensure the PPF Board could continue to manage the FCF effectively. [38]

[34] Pensions Act 2004, s184; PPF leaflet, All you need to know about the Fraud Compensation Fund, p3
[35] Pensions Act 2004, s189; Occupational Pension Schemes (Fraud Compensation Levy) Regulations 2006 (SI 2006/558)
[36] SI 2006/558, reg 3 (3) (b)
[37] Explanatory Memorandum to SI 2006/558, para 7.3
[38] Occupational and Personal Pension Schemes (Miscellaneous Amendments) Regulations 2011/672, reg 8; Explanatory Notes, para 7.6

Other levies on occupational pension schemes

Pension Protection Fund levy paid by all schemes eligible for the PPF i.e almost all DB schemes and with a DB element, s175.

The PPF and FCF levy are "ring-fenced and cannot lawfully be used to supplement each other. Both the FCF itself and the fraud compensation levy are much smaller than the PPF and the pension protection levy." (PPF written evidence to the Work and Pensions Select Committee, Sept 2020)

There is also a general levy on occupational and personal pension schemes, which recovers the funding provided by DWP for the core activities of the Pensions Regulator, Pensions Ombudsman and the pensions-related activities of the Money and Pensions Service. (Pension Schemes Act 1993, s168,175, 181-2; S.I. 2005 No. 626). DWP recently consulted on increases to the general levy for the years 2022-24 and a review of its structure. It said that "were levy rates were to remain unchanged, there would be a deficit of around £230m at the end of 2023 to 2024 (DWP, The Occupational and Personal Pension Schemes (General Levy) Regulations review 2020).

When the FCF levy has been raised

In 2010/11, the PPF Board raised a Fraud Compensation Levy for the first time since 2004. This was at the rate of 23p per eligible pension scheme member. It raised a levy again in 2011/12 and 2012/13. [39] This was necessary due to the expected cost of claims. [40]

No levy was raised in 2013/14 on the basis that the 2012/13 levy had left the FCF adequately funded based on known claims and expected recoveries from third parties. No levy was raised in the years 2014/15 to 2016/17. [41]

In 2017/18 and 2018/19, the PPF Board raised a levy of 25 pence per member amounting to a levy of £4.3m in 2017/18 and £4.8m in 2018/19. [42] It commented that the volume of claims on the FCF remained at low levels. However, this meant that the PPF Board did not have enough statistics to forecast the level of future claims accurately and it therefore remained "vulnerable to an

[39] PPF Annual Report and Accounts 2010/11, HC 1559, October 2011

[40] PPF Annual Report and Accounts 2011/12, HC 623, October 2012 p22

[41] PPF Annual Report and Accounts 2012/13, October 2013, p26; PPF Annual Report and Accounts 2013/14, HC 489, July 2014, p25; PPF Annual Report and Accounts 2015/16, HC 461, July 2016, p64; PPF Annual Report and Accounts 2016/17, HC 147, July 2017, p84

[42] PPF Annual Report and Accounts 2017/18, HC 1229, July 2018, p52 and 35; PPF Annual Report and Accounts 2018/19, HC 2158, July 2019 p111

unexpected rise in the volume of claims or unusually large or urgent claims.” [43]

The PPF Board raised an FCF levy of £6.9m in 2019/20, noting again that the Fund was “vulnerable to large claims” which “could materialise from new claims on the Fund or from significant claims relating to schemes that were themselves part of a scam where eligibility remains unclear.” To enable it to meet these claims, the Board “maintained its funding strategy for the FCF which is to build up a reserve in the Fund by raising a levy where necessary.” Any funding gap was “expected to be considered by the DWP.” [44]

In April 2021, the PPF Board said that following the High Court judgement discussed below, it would need to raise the maximum allowed under the regulations:

> Our 2019/20 Annual Report and Accounts confirmed the FCF had assets of £21.5 million, and if claims exceeded the current assets of the Fund, we’d need to seek additional funding.
>
> Given the value of the claims we’ve already received and our expectation that, following the court ruling, further claims will be made, we need to raise a levy of 75p per member (30p for master trusts) in 2021/22. This is the maximum allowed under current regulations. [45]

3.4 Claims on the FCF

When the 2004 Act was before Parliament, Ministers explained that calls on the FCF were expected to be rare: in its seven years of operation since 1997, the Pensions Compensation Board had only needed to make payments in three cases, totalling less than £570,000. [46] The claims the FCF faced in its early days were likely to relate to employers who had failed to pay contributions deducted from their employees’ wages, or straightforward cases of fraud. [47]

In its evidence to the Work and Pensions Select Committee in November 2020, the PPF said that since its establishment in 2004, the FCF had received 47 applications for compensation for dishonesty:

> Of these, 37 were from genuine schemes which had themselves been subject to fraud. These are clearly within the remit envisaged for the

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43 PPF Annual Report and Accounts 2018/19, HC 2158, July 2019 p111

44 PPF Annual Report and Accounts 2019/20, HC 796, July 2020, p122

45 Fraud compensation levy for 2021/22 confirmed, PPF press release, 1 April 2021; Fraud Compensation Fund Levy for 2021 confirmed, FCF press release, 28 June 2021

46 Pensions Bill Deb, 1 April 2004, c 603 [Chris Pond];HL Deb 13 September 2004 c272 GC [Baroness Hollis of Heigham]

47 PBC Deb, 15 June 2021, c15

> FCF. Of the 37, the FCF has paid out compensation totalling approximately £5.4 million in respect of 14 claims. Seventeen claims have been rejected and six were withdrawn. [48]

A further ten claims were from independent trustees appointed by the Pensions Regulator to schemes that were themselves used to scam individual pension savers. [49] The position regarding these schemes was the subject of the High Court judgement discussed below.

3.5 High Court judgment

In September 2020, the PPF said it had initiated a legal process to test whether claims relating to pension schemes that were themselves used to scam individual pension savers were eligible for FCF compensation. In its evidence to the Work and Pensions Select Committee it said:

> In the context of pension scheme transfers, the FCF was set up to cover circumstances in which members might transfer to a legitimate occupational pension scheme which itself was then scammed,
>
> However, the form of pension scam in which individuals were enticed to transfer their savings into a scam pension scheme, from which the fraudsters could then extract the money, was not prevalent when the legislation written.
>
> As a result, the legislation (the Pensions Act 2004) was not designed with such scams on individual members in mind. We have been actively progressing and reviewing the 10 claims referenced above as far as we are able, but the legislation as written does not give us clarity over whether they are eligible for FCF compensation or not. With the overriding aim of providing some form of clarity for affected members, last year we initiated a legal process seeking clarity on the ambiguities in the legislation. This was done in collaboration with Dalriada Trustees, independent trustees appointed by TPR to oversee some of the applicant schemes, and DWP. [50]

In a judgement issued on 6 November 2020, which had immediate effect, the High Court determined that such "pension liberation schemes" were eligible to apply to the FCF for compensation. [51] (Pension liberation fraud involves members being persuaded to transfer their pension savings from legitimate schemes to fraudulent schemes, with promises of high investment returns or

[48] Evidence from the Pension Protection Fund to the Work and Pensions Select Committee, September 2020

[49] Ibid

[50] Evidence from the Pension Protection Fund to the Work and Pensions Select Committee, September 2020

[51] Dalriada v Board of the Pension Protection Fund [2020 EWHC 2960 (Ch)]

access to a loan from their pension scheme before the age of 55 without incurring a tax charge. [52])

The PPF responded that the Court had clarified how the legislation should be interpreted:

> We've received a number of claims to the FCF to compensate members of occupational pension schemes that were themselves part of a scam. Pension savers were incentivised to transfer their pension from a genuine occupational pension scheme into these scam schemes. [...] The court has now confirmed that these types of claims are eligible for FCF compensation, and clarified the core principles that apply. [53]

It said it would now work with independent trustees to process the applications. The investigative work – which would take some time – was likely to include assembling evidence to show where dishonesty had taken place, obtaining and analysing member and financial information, and actively pursuing the recovery of scheme assets. [54]

In March 2021, the *Financial Times* reported that the FCF would begin processing cases through to settlement within 12-18 months. The director of strategy and policy at the PPF described the judgment as "very good news" for scheme members and the start of a "relatively big step change" in terms of running the fund. The FCF had already received around seven relevant claims with a potential value of more than £40m and more claims were expected in the very near future. [55]

Chair of the Work and Pensions Committee, Stephen Timms, described the judgement as a "significant development" which opened the door to a source of compensation for victims of some pension scams. [56]

Impact on FCF funding

The PPF has estimated that compensation payments claimed as a result of the High Court judgment, will be in the region of £350 million. At the time of the judgement, the FCF had assets of £26.2m. Even with future levy income, the expectation was that there would be unfunded liabilities in the region of £200m to £250m. [57]

It is reasonably confident in this estimate, which was based on information gleaned in relation to those cases from liaison with the professional trustees and/or the Pensions Regulator. [58] Although there is no legal reason why the

[52] HC Deb 8 June 2020 c906 [Guy Opperman]
[53] Fraud Compensation Fund eligibility criteria confirmed, PPF press release, 12 November 2020
[54] Fraud Compensation Fund eligibility criteria confirmed, PPF press release, 12 November 2020
[55] Pension fraud fund to start processing cases within 18 months, *FT adviser,* 12 March 2021
[56] HC Deb 16 November 2020 c65; Protecting pension savers: five years on from the pension freedoms: pension scams, Fifth report of 2019-20, 28 March 2021, para 139
[57] Bill 9-EN, para 8-9
[58] PBC Deb, 15 June 2021 c14

fund could not get more claims in future, such cases are "predominantly historical in nature," pension liberation fraud being less likely to occur following the introduction of the pension freedoms. [59]

Representatives of Master trusts (multi-employer schemes commonly used by unconnected employers for auto-enrolment [60]) have expressed concerns about the impact of the levy. [61] In evidence to the Public Bill Committee on 15 June 2021, Philip Brown of B&CE, providers the People's Pension, said raising a levy of £350 million using the same mechanism would have a disproportionate impact on those two Master Trusts – NEST and the People's Pension. They had paid approximately 37% of the Fraud Compensation levy in 2019, despite holding only around 1% of the assets in the workplace pensions sector. He argued that a fundamental review is necessary for how levies are calculated. [62]

3.6 Legislative context

Section 115 of the PA 04 enables the PPF Board to "borrow money subject to a prescribed borrowing limit, which is specified by the Secretary of State (by order)." It is permitted to borrow from a "deposit taker" and to provide security for any money it borrows. [63]

When the legislation was before Parliament, the Government explained that this would enable the PPF Board "to borrow commercially in order to manage its short-term liquidity." It was not designed to be a long-term method of funding either the PPF or the FCF. [64] The Government would not act as a lender due out of concerns that this could give rise to the 'moral hazard' - with those responsible for running DB schemes failing to exercise due diligence and relying instead on "government hand-outs as lenders of last resort in order to bankroll them." [65]

Section 116 of the 2004 Act enables the Secretary of State to pay the Board grants towards administrative expenses. This money cannot be used for the payment of compensation from either the PPF or FCF. [66]

[59] Ibid c13
[60] DWP, Auto-enrolment evaluation report, May 2020
[61] PBC Deb, 15 June 2021 c21
[62] Ibid c22
[63] Pensions Act 2004, s115
[64] HL Deb 19 July 2014 c23-3GC [Baroness Hollis of Heigham]
[65] Ibid c25GC
[66] PA 04 – Explanatory Notes, para 377

3.7 The Bill

Clause 2 (1) of the Bill would amend the Pensions Act 2004 – inserting a new section 115A - to enable the Secretary of State to lend money to the Board of the PPF for purposes of the exercise of the Board's functions under Chapter 4 of Part 2 PA 04 (Fraud Compensation) and any corresponding provision in force in Northern Ireland.

Any such loan may be made on such terms (including as to repayment and interest) as the Secretary of State may determine (clause 2 (2)).

Clause 2 (3) would amend section 115 PA 04 to provide that the limits on borrowing under that section would apply only to loans under that section, not to any loan from the Government under the new section 115A.

Clause 2 (4) would amend section 188 PA 04 to provide for the contents of the Fraud Compensation Fund to include money borrowed from the Government under section 115A and for permitted payments from the Fund to include repayments of money borrowed from the Government.

The Explanatory Notes state that a loan under these new provisions to the PPF board would be repaid by the FCF levy on occupational pension schemes and that there will be no impact on DWP expenditure in the long-term:

> The loan is estimated to be within a range of £200-£250m and will be repaid by the FCF levy on eligible pension schemes. The FCF levy rates and repayment period, currently estimated to be between 10 and 15 years, will be subject to formal consultation, which is timetabled for Autumn 2021. [67]

The provisions in clause 2 are intended to extend and apply, to England and Wales, Scotland and Northern Ireland. Occupational pensions are a transferred matter in Northern Ireland, so a Legislative Consent Motion for Northern Ireland will be required. [68]

[67] Bill 9 - EN, para 9
[68] Bill 9 - EN, para 20-22

4 Commons Second Reading

The Second Reading of the Bill took place on 8 June 2021. The Bill was passed without a division.

Introducing the Bill, Pensions Minister, Guy Opperman, highlighted the Government's role in ensuring that the regulation of financial services was "suitably robust." The two measures in the Bill responded to situations where "firms fail, or there are bad actors intent on committing fraud." [69] The Bill was "necessary, urgent and important" to ensure "financial protection and fair outcomes for those falling victim in these particular circumstances." [70]

Pat McFadden, the Shadow Economic Secretary, argued that the Bill was a limited response to a much wider problem. He said both measures set out to compensate people who were victims of fraud, but the Bill did not address "a regulatory system that is lagging behind what is actually happening in the financial markets." Failure to tackle financial crime in any forthcoming online harms legislation would be a "lost opportunity":

> It is critical that the laws that we pass in this place keep pace with the innovations in fraud and financial crime that are taking place. For that to happen, it will take a lot more than the two clauses on compensation in this Bill. [71]

Summing up the debate, John Glen, the Economic Secretary, acknowledged the wide support across the House for the principles of the Bill. He hoped that it would "offer some relief to the enormous distress and hardship suffered by LCF bondholders and victims of fraudulent pension liberation schemes." He wanted "to move as quickly as possible from Royal Assent to enact [the legislation] and deliver that compensation." [72]

Most of the contributions referred to the proposed LC&F compensation fund. The following sections summarise some of the main issues raised in relation to the two measures.

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[69] HC Deb 8 June 2021, c904

[70] HC Deb 8 June 2021, c906

[71] HC Deb 8 June 2021, c910-911

[72] HC Deb 8 June 2021, c917-919

4.1 London Capital & Finance compensation fund

Confidence in the FCA's approach

Although the Bill is narrowly focused on processes for establishing the compensation fund, some participants raised questions about wider concerns referred to in the Gloster Report. Leading for the Opposition, Pat McFadden referred to "a litany of regulatory failures", including not responding to concerns raised by investors, not stepping in to deal with misleading promotion by LC&F, and poor communication within the FCA. He argued that earlier action could have saved the taxpayer the £120 million in compensation now proposed. [73]

Mr McFadden also highlighted the Gloster Report's references to concerns about the accountability of the FCA's leadership and cases where reports and complaints were not taken forward. He concluded by arguing the importance of looking beyond the focus of the current Bill:

> These broader questions matter, because with ever more complex financial markets, the regulators have to be equipped to do the job—equipped through their leadership and their systems, but also through the resources at their disposal. Part of the backdrop to this is the FCA taking on responsibility for tens of thousands more firms after it took on the responsibilities of the Office of Fair Trading back in 2014. Is the Minister confident that it has the resources after the LCF collapse? [74]

Mel Stride, Chair of the Treasury Select Committee, reiterated the findings of the Gloster Report, noting that it had found that "the level of the failings on the part of the FCA [was] very clear." [75] John McDonnell mentioned the Government's earlier unwillingness to delay the appointment of the former Chief Executive of the FCA as Governor of the Bank of England, "given the concerns." [76] Rebecca Long Bailey noted wider regulatory failings – auditors had simply "waved through [LC&F's] accounts" in 2016, and again in 2018 when it was "all but insolvent." [77]

Responding to an earlier intervention about management accountability from Kevin Hollinrake, Pensions Minister, Guy Opperman, acknowledged the depth of concern about accountability:

> Clearly, it is not possible to comment on specific future events, but Ministers are liable for the actions of civil servants, through vicarious liability, and we would expect regulators to take a similar approach and, putting it simply, to own the problems they are trying to solve. If

[73] HC Deb 8 June 2021, c907
[74] HC Deb 8 June 2021, c909
[75] HC Deb 8 June 2021, c911
[76] HC Deb 8 June 2021, c914
[77] HC Deb 8 June 2021, c916

> that is a lesson learned from this sorry saga, in my humble opinion that would be a good thing. Clearly, it is for the FCA to take a good long, hard, look at itself, and other regulatory bodies, and decide how it will run itself going forward, with suitable input from Government. [78]

Summing up the debate, the Economic Secretary highlighted the FCA's transformation programme, which "is designed to empower the organisation at all levels to hear the representations that the right hon. Member for Wolverhampton South East (Mr McFadden) made, to act on them, and to deal proactively with the cases that are raised." [79]

The regulatory perimeter and the 'halo effect'

Further to the wider concern above, various Members raised the more specific issue of how well and how far the FCA had handled the limitations of its regulatory perimeter and the 'halo effect' – the incorrect assumption that all of an authorised firm's activities and products would be regulated and therefore protected.

Mr Stride argued that

> [t]he FCA's approach to the perimeter was limited. It did not take a holistic view of the perimeter and therefore there was inadequate supervision of unregulated activities. The halo effect, which the shadow Minister also raised, was without doubt a wider systemic problem within the FCA. [80]

Mr McFadden quoted the Gloster Report's conclusion that "a substantial proportion" of bondholders had only invested because LC&F was an authorised firm. [81] Sammy Wilson added that the Report had noted that FCA staff "were actually assuring the public that the claims being made by LCF were correct and that their savings were safe." [82] while Neale Hanvey contended that "the regulator was at fault in encouraging other people…to invest in that scheme." [83] (See the previous and following sub-sections for the Government's wider response.)

An exceptional case?

Since its initial response to the findings of the Gloster Report in December 2020, the Government had justified the establishment of the compensation fund for LC&F investors as an exceptional case. [84]

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[78] HC Deb 8 June 2021, c905
[79] HC Deb 8 June 202, c919
[80] HC Deb 8 June 2021, c911
[81] HC Deb 8 June 2021, c909
[82] HC Deb 8 June 2021, c915
[83] HC Deb 8 June 2021, c907
[84] UIN HCWS678, 17 December 2020

While no speaker in the debate challenged the need for such a fund, several questioned how exceptional the circumstances were, how the Government came to such a conclusion, and how it could be confident that other similarly compelling cases would not arise in future.

On behalf of the SNP, Peter Grant argued that there were already other broadly similar situations coming to light, including Equitable Life, Premier FX, Connaught, Henley pensions and Blackmore Bond.

Mr Grant went on to suggest that the Government should in fact legislate to enable similar schemes to be made available to victims of financial scams "without them having to wait for a public inquiry and a new Act of Parliament for every single one." [85] John McDonnell said the Bill needed to address the failures of regulation, governance and auditing. [86]

Pat McFadden asked about the Government's rationale for declaring the LC&F case exceptional and given that it did consider it to be so, both Mr McFadden and Ms Long Bailey asked why it had decided to limit compensation to 80% of what the Financial Services Compensation Scheme would offer (for regulated activities).

In response, the Economic Secretary stated that after "detailed analysis" of failed mini-bond schemes, "the Government are satisfied that the circumstances surrounding LCF are truly exceptional." He continued:

> [T]he issuance of mini-bonds is not regulated by the FCA. As my hon. Friend the pensions Minister set out, LCF was an FCA-authorised firm despite not receiving any income from regulated activities. LCF is unique in that regard; indeed, it is the only mini-bond issuer that was authorised by the FCA and that sold bonds to on-lend to other companies. That is important, because one of the central findings in Dame Elizabeth Gloster's excellent report is that because LCF was authorised, the FCA should have considered its business holistically, including the unregulated activity of issuing mini-bonds.

Crucially:

> The FCA cannot be said to have the same responsibilities with regard to unauthorised firms. Although the Government have not seen evidence to suggest that the regulatory failings at the FCA caused the losses for bondholders, they were a major factor that the Government considered when deciding to establish the scheme. [87]

He acknowledged the hardship that other failures had caused investors, but reiterated the importance of **not** compensating every failure:

> I must be clear that the Government cannot step in to pay compensation in respect of every failed financial services firm. That

[85] HC Deb 8 June 2021, c913

[86] HC Deb 8 June 2021, c914

[87] HC Deb 8 June 2021, c918

> falls outside the financial services compensation scheme, would create a moral hazard for investors and would potentially lead individuals to choose unsuitable investments, thinking that the Government would provide compensation in all cases if things went wrong.

Mr Glen noted that this would be only the third such scheme in thirty years. He concluded by noting that the Government was "seeking to ensure that the situation never arises in the future. In April, we launched a consultation with proposals to bring mini-bonds into FCA regulation." [88]

4.2 Fraud Compensation Fund

The Pensions Minister, Guy Opperman, explained that clause 2 would give the Secretary of State a power to lend money to the board of the Pension Protection Fund. This would "allow compensation to an estimated 8,806 individuals who have been defrauded following the pronouncement of the recent Court judgment in the Dalriada case." The Court had concluded that pension liberation schemes would be eligible for the Fraud Compensation Fund, subject to meeting the criteria. The Government had accepted the judgement. However, the value of the claims was far greater than the assets currently held in the Fund, hence the need for clause 2. [89]

The shadow Economic Secretary, Pat McFadden, argued that the right approach must be to ask why more pensioners were being exposed to fraud and scams in the first place. The cost of the increased claims on the Fraud Compensation Fund would ultimately have to be met through increased fraud compensation levies, which would have to be paid by schemes that were trying to offer a good service to their members. He said it was "critical that the laws that we pass in this place keep pace with the innovations in fraud and financial crime that are taking place." [90] For the SNP, Peter Grant supported clause 2, saying that the pensioners should be compensated. However, more was needed "to make people's pensions and investments safe from the crooks. [91] Jim Shannon of the DUP agreed. [92]

Winding up the debate, Mr Glen, said clause 2 was "vital to ensure that those defrauded of their pensions by scam pension liberation schemes are able to access the compensation that they deserve." He and the Pensions Minister were working across Whitehall to meet the "ongoing challenge of dealing with the evolving nature of financial services firms and the sophistication of scams." [93]

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[88] HC Deb 8 June 2021, c918
[89] HC Deb 8 June 2021, c906
[90] Ibid c910
[91] Ibid c913
[92] Ibid c917
[93] Ibid c919

5 Public Bill Committee stage

There were two sittings of the Public Bill Committee on 15 June 2021. In the first sitting the Committee took evidence from Dame Elizabeth Gloster, the FCA, the Financial Services Compensation Scheme, the Pension Protection Fund and other stakeholders. In the second sitting, the Committee debated seven Opposition-tabled amendments . The Chairs of the Committee were Nusrat Ghani and Peter Dowd. [94]

The Committee made no changes to the Bill. Labour Members put forward six amendments and the SNP one (amendment 7). [95] All were withdrawn after debate. [96] Four amendments related to the proposed LC&F compensation fund and three to the Fraud Compensation Fund.

5.1 LC&F compensation fund

Is the LC&F case exceptional?

Amendments 1 and 7 proposed specific arrangements to require the Secretary of State to specify how the Government had determined that the collapse of London Capital & Finance was an appropriate case for a compensation fund and how such considerations would apply in future. Amendment 7 also requested more detail about why compensation would be capped at 80% of the corresponding FSCS limit.

Moving amendment 1, Mr McFadden reiterated findings from the Gloster Report about the degree of regulatory failure and investors' belief that LC&F mini-bonds benefited from a "stamp of respectability" – partly resulting from references to FCA authorisation in LC&F advertising, and partly from their inclusion in an ISA wrapper. He highlighted "the apparent legislative lacuna" in which the FCA and HMRC both appeared to believe that the other was responsible for such oversight. [97]

Mr McFadden focused on the assertion made by both Ministers during Second Reading that what made the case exceptional was that LC&F was "the only

[94] PBC Deb, 15 June 2021, c1
[95] Compensation (London Capital & Finance plc and Fraud Compensation Fund) Bill (Amendment Paper), 15 June 2021
[96] HC Deb 15 June 2021 [Compensation (London Capital & Finance plc and Fraud Compensation Fund) Bill (Second sitting)].
[97] HC Deb 15 June 2021, c32

mini-bond issuer that was authorised by the FCA and that sold bonds to on-lend to other companies." He noted:

> That is an exact replica, with both Ministers saying the same thing, and I suspect that that phrase has been very carefully honed inside the Treasury. A case had to be made for the uniqueness of this that could not be applied to other investment failures, so I think that form of words is very carefully chosen. [98]

Given the other instances of mini-bond failures, he wondered quite why this case was unique. After the Economic Secretary rose again to confirm the focus on on-lending, Mr Mc Fadden stated that he wanted

> to clarify exactly what might place the taxpayer on the hook. Does it require the kind of report carried out by Dame Elizabeth Gloster and commissioned by the FCA into the collapse of LCF? Is there a clear threshold of regulatory failure to be passed? [99]

Moving amendment 7, Peter Grant further questioned the Government's reasoning. He noted that the Bill had been framed in such a way as to limit its potential widening to cover other failures. In many such cases, though, "investors in those companies were misled into believing that someone else's registration would cover them." He went on:

> If the Government constantly remind us that the sale of mini-bonds was not regulated by the Financial Conduct Authority, surely the elephant in the room is: why on earth not?
>
> The Government will, I know, refer to the principle of caveat emptor. It is correct that anyone making an investment has a responsibility to ensure that the investment meets their needs, but there are hundreds—possibly thousands—of examples in UK regulation where we regulate the market but it is not realistic or fair to expect the emptor to caveat.
>
> We do not expect people to do their own personal survey of a house to make sure it is safe before they buy it. We do not expect people to check the brakes on the bus before buying a ticket. [100]

In response, and before repeating the Government's position on the case of LC&F, Mr Glen noted that

> With the right set of regulations and requirements…investors can be equipped with the right information to understand their risks and to make informed choices. The Government's scheme appropriately balances the interests of both bondholders and the taxpayer, and it

[98] HC Deb 15 June 2021, c31

[99] HC Deb 15 June 2021, c33

[100] HC Deb 15 June 2021, c34-35

> will ensure that all LCF bondholders receive a fair level of compensation for the financial loss they have suffered. [101]

With regard to the question of on-lending, he added:

> There is a distinction between a firm, such as BrewDog or Hotel Chocolat, that raises funds for its own business activities and a firm that, although authorised, has not carried out regulated activities. Through the failure of the FCA's oversight to look at the broader activities of the firm, it is impossible to verify whether those activities on lending bore any relationship to the raising of funds for that business. That is the distinctive difference. It is that failure of the FCA to execute its broader responsibility for an authorised firm carrying out an unauthorised activity in this distinct area that gives us licence to intervene. [102]

Referring to the two other cases where the Government **had** set up compensation schemes, he argued that although they shared "a degree of maladministration or misregulation…the circumstances are idiosyncratic." This made it impossible to set up a "precise framework" or "to stipulate the threshold of misregulation" that might apply in future cases. Doing so might also promote "unreasonable expectation" of Government recompense among investors. [103]

He also highlighted continuing progress on responding to the Gloster Report's wider recommendations. [104]

Both amendments were withdrawn, but in conclusion Mr Mc Fadden noted:

> I am not entirely convinced about the relationship between on-lending and the decision to compensate…The mini-bonds were not doing what it said on the tin: they were not on-lending but pyramid selling…I am not convinced that all the elements of the Government's case add up. It looks to me as though they have had to find a unique element to insulate themselves from court action or other claims. [105]

Reporting progress on implementing recommendations

Amendment 2 would have required the Secretary of State to report to Parliament on progress with implementing the recommendations of the Gloster Report.

Introducing it, Mr McFadden noted that Dame Elizabeth Gloster's overriding conclusion was the importance and degree of culture change required for the FCA to fulfil its duties. He highlighted a number of the main

[101] HC Deb 15 June 2021, c38
[102] HC Deb 15 June 2021, c39
[103] HC Deb 15 June 2021, c39
[104] HC Deb 15 June 2021, c40
[105] HC Deb 15 June 2021, c40-41

recommendations, including the need to treat companies holistically (and so overcome the halo effect), dealing with comments and complaints more effectively, considering the importance of financial promotions, and the underlying issue of how the FCA interpreted its actions in the context of its regulatory perimeter. He also noted the importance of legislation responding to technological advances. While relevant parties had accepted the recommendations, would it be sufficient, he asked, to accept such assurances? He emphasised potential resource issues for the regulator, not least those arising from taking on new responsibilities after Brexit. [106]

Peter Grant highlighted Parliament's role in holding the FCA to account. He cautioned that

> We have had far too many examples of Ministers giving assurances in good faith but of things not happening or, if they did happen, of their taking far longer than they should have done
>
> [...]
>
> If the Minister is not prepared to commit to giving an update within six months, will he tell us what timescale he thinks is reasonable for us to expect real change? "In due course" is just not good enough for people who might be losing their investments now even while we dither and dally about what to do next. [107]

Gareth Thomas reiterated those comments, going on to note that he had seen little evidence of culture change in how the FCA was dealing with consumers in a demutualisation case. [108]

In response, the Economic Secretary said that he was "sensitive to the criticism that this is an empty exercise where there is nothing specific that Parliament and Members can address." But he went on to highlight that the Chair of the FCA has already updated him on "the comprehensive improvements that have already been delivered." The FCA would provide further updates in its annual report in July, and had undertaken to continue to report every six months. The Treasury Committee would also shortly publish its report. [109]

He went on to note that

> [In] financial services legislation that we took through Parliament together, we gave the FCA responsibility to remove the names of firms that do not conduct any activities but are regulated under the FCA, and so remove the halo effect. I watch and monitor the transformation programme very closely, but I think that the amendment would create an additional and unnecessary

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[106] HC Deb 15 June 2021, c41-44

[107] HC Deb 15 June 2021, c45-46

[108] HC Deb 15 June 2021, c45-46

[109] HC Deb 15 June 2021, c48-49

> administrative burden given the commitments that I have set out, and would distract from the work to deliver the recommendations themselves. [110]

Mr McFadden withdrew the amendment. [111]

5.2 Fraud Compensation Fund

Introducing amendment 3 – to prevent a loan under clause 2 before the Secretary of State has laid before Parliament an impact assessment of the FCF levy on different pension sectors – Shadow Pensions Minister, Matt Rodda, argued that under the current mechanism the burden of compensation would fall disproportionately on two Master Trusts, the People's Pension and NEST. They had paid 37% of the Fraud Compensation Levy in 2019, despite managing only around one per cent of the assets held in UK workplace pensions and were understandably anxious about where the burden of the increased levy would fall:

> We have been promised a review of the levy later this year, and I appreciate that the Government are willing do that. However, it does not seem right that, given the significant sums involved for the loan, the legislation should proceed without pausing—all we are asking for is a pause—to consider its impact. [112]

Responding, Pensions Minister, Guy Opperman opposed the call for an impact assessment saying "it would fundamentally delay the implementation of payment to members, and the blunt truth is that the PPF will run out of money by October if we do not progress this legislation." He accepted there were points to be made in respect of how the loan was to be repaid in the longer term. The levy increase would "be consulted on post the passing of this Bill. It will need consultation, regulations and debate in the usual way." [113]

Introducing amendment 5 – to require a report on the levels of fraud in the pensions system before making any loan under clause 2 – Mr Rodda argued that this was a crucial first step in tackling pension fraud. [114] Mr Opperman responded that the Government would respond to the Work and Pensions Committee's report on pension scams before the end of the summer term. [115] The Government was already progressing Project Bloom, had consulted on regulations to protect people from pension scams through transfers from one scheme to another, was engaging with tech organisations to protect people

[110] HC Deb 15 June 2021, c48-49

[111] HC Deb 15 June 2021, c49

[112] PCB Deb 15 June 2021 c52-3

[113] Ibid c58

[114] Ibid c56; HC Deb 16 November 2021 c63 and c114-6; Commons Library Briefing Paper CBP 8693, p60

[115] Ibid c59; Protection pension savers: five years on from the pension freedoms. Pension scams, Fifth report of 2019-21, HC 648, 24 March 2021

from online scams and working to increase take-up of Pension Wise. [116] Mr Rodda withdrew his amendments, Mr Opperman having agreed to further dialogue on the issues. [117]

[116] Ibid c59; DWP, Pension scams: empowering trustees and protecting members consultation, May 2021
[117] Ibid c60