Labour Briefing Notes:
Compensation (London Capital & Finance plc and Fraud Compensation Fund) Bill

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

OVERVIEW

This briefing note provides a background to understanding the Government's Bill[1] which seeks to create a compensation scheme for investors in London Capital and Finance (LCF), a company which went into administration in January 2019. The Bill was introduced in the House of Commons on 12 May 2021and had its second reading[2] on 8th June 2021. The Committee stages[3] were completed on 15 June 2021. The third reading[4] was completed on 22 September 2021 and the Bill was passed unamended.

In February, March and April 2021, the House of Commons Treasury Committee[5] had held hearings on regulatory failures relating to the collapse of LCF. A report[6] was published on 24 June 2021.

The Bill is scheduled for its second reading in the House of Lords on 19 October 2021. All other stages are also to be completed on the same day.

The essence of the Bill is that the names of the scandals change but underneath there is the familiar story of privatising profits, socialising losses, frauds, fiddles, mis-selling, negligent regulators and ineffective auditors, whilst innocent parties pick up the tab. Thousands of innocent people are harmed. As usual, the state cleans up some of the mess left by the finance industry, but does not accept responsibility for the failures.

BACKGROUND TO LONDON CAPITAL AND FINANCE

1. London Capital and Finance started life in 2012 and was a small company. Its audited financial statements for the year to 31 March 2015, showed turnover of £82,610 and pre-tax profit of £29,294. The company described its business "raising and lending of funds". At that point it had not been authorised by the Financial Conduct Authority (FCA).

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[1] https://bills.parliament.uk/publications/41483/documents/210
[2] https://hansard.parliament.uk/Commons/2021-06-08/debates/EBCC9AFC-8D24-40C0-8507-A009A57B0692/Compensation(LondonCapitalAndFinancePlcAndFraudCompensationFund)Bill
[3] https://hansard.parliament.uk/commons/2021-06-15/debates/0e4bf128-f6a3-4922-b1d3-5a880f7b89a2/Compensation(LondonCapitalAndFinancePlcAndFraudCompensationFund)Bill(SecondSitting)
[4] https://hansard.parliament.uk/commons/2021-09-22/debates/480AFB46-A34A-4BD7-A9DB-405971E2DE37/Compensation(LondonCapitalAndFinancePlcAndFraudCompensationFund)Bill
[5] https://committees.parliament.uk/oralevidence/1636/html/
[6] https://committees.parliament.uk/publications/6397/documents/70132/default/

2. As early as October 2015, investors were raising concerns about lending money to LCF on Moneysavingexpert[7] with expressions such as “sounds dodgy”.

3. On 7 June 2016, the FCA approved LCF application for authorisation which was for corporate finance business only. Its loan notes remained unregulated. The authorisation by FCA gives legitimacy to the business and LCF used it to target the ISA transfer market by using the Finance ISA wrapper even though LCF’s bonds were not eligible for ISA status. Throughout its life, LCF remained an FCA-authorised firm even though it did not generate any income from regulated activities. Its entire income came from unregulated activities.

4. LCF targeted ordinary savers by offering them high returns of 8 per cent on its 'mini-bonds’. In times of low interest rates on savings, such returns are tempting.

   According to the FCA “There is no legal definition of a ‘mini-bond’, but the term usually refers to illiquid debt securities marketed to retail investors. It is essentially an IOU issued by a company (the issuer) to an investor, in exchange for a fixed rate of interest over a set period. At the end of this period, the investor’s money is due to be repaid. The return on investors’ money depends on the success and proper running of the issuer’s business. If the business fails, investors may get nothing back”[8].

5. LCF was also linked with politicians. For example, Conservatives MP Johnny Mercer received £85,000 from Crucial Academy, a company ultimately funded by Surge Financial Limited. Surge Financial Limited took 25% commission for marketing LCF bonds. The Conservative MP for Plymouth Moor View is a non-executive director of Crucial Academy[9].

AUDITS

6. The accounts for the year to 30 April 2015 were audited by Messrs Oliver Clive & Co. Ltd. The company had turnover of £14,072; profit of only £782 and share capital of just £1,000.

7. The financial statements for the year to 30 April 2016 showed turnover of £948,201; profits of £166,916 and share capital of £50,000. Its net assets were only £25,592 and it little capacity to absorb any shocks or losses. The accounts were audited by PricewaterhouseCoopers (PwC) and raised no concerns about the business model or its legal status.

   LCF had only two employees with a wage bill of £9,352. The 2016 accounts probably formed the basis of authorisation by the FCA. There may have been some correspondence about them between PwC and the FCA.

[7] https://forums.moneysavingexpert.com/discussion/5346049/london-capital-and-finance
[8] https://www.fca.org.uk/consumers/mini-bonds
[9] https://www.bbc.co.uk/news/uk-england-devon-47884273

8. The 2017 accounts were audited by Ernst & Young and raised no concerns about the business model, its legal status or ability to recover loans of £48m or redeem bonds of some £44.5m. The company had only six employees with a wage bill of £96,479. Were they skilled?

   Its equity capital was only £50,000 and provided virtually no buffer against any losses. Its net assets of £298.827 were utterly inadequate to provide any buffer against failure of borrowers to make payments.

   The balance sheet showed net assets of only £298,000, indicating that LCF was extremely highly leveraged, with a loan to net asset ratio above 160:1[10].

   LCF expected to redeem £4,830,504 of mini-bonds (shown as current liabilities in its 2017 balance sheet) but only had £1,821,351 of cash or cash equivalent (shown as a current asset). So could LCF meet its liabilities as they fell due? This is an example of a test of company solvency?

   One assumes that auditors must have been satisfied that LCF would conjure up some resources. How? Ernst & Young said that the company was a going concern.

   Right from the beginning, it should have been evident to auditors, and the FCA, that LCF bonds were high-risk as the company was lending to many new, often small businesses, and therefore the risk of loss/default was very high. The company's accounts and auditors do not show any acknowledgement of such risks.

9. LCF had low equity base, high leverage and low cash and that raised major questions about its business model. It relied upon the inflow on new money to redeem loans from investors. The directors' report claimed that "the structure, interest profile and maturity of the company's loan portfolio is expected to provide adequate liquidity to meet the company's commitments to borrowers as well as providing a high degree of certainty that the company will generate revenues that will exceed the company's expenditure base". Yet auditors did not show any scepticism.

10. LCF had three auditors. Accounts for the year to 30 April 2015 were audited by Oliver Clive & Co.; the year ended 30 April 2016 was audited by PwC and the year ended 30 April 2017 was audited by Ernst & Young. All deemed the company to be a going concern and gave it a clean bill of health. The FCA did not seem to have been concerned about the low equity base, high leverage and low cash flows.

ADMINISTRATION

11. On 30 January 2019, LCF went into administration. At that point LCF had 11,625 bondholders with an investment of around £237m and expected major losses.

[10] https://www.ft.com/content/09df4f72-5222-11e9-9c76-bf4a0ce37d49

12. Finbarr O'Connell, Adam Stephens, Colin Hardman and Henry Shinners, from Smith & Williamson LLP, were appointed administrators.

13. The administrators have said that most of the LCF cash was invested in just 12 companies, many of them with close connections to LCF's founder Simon Hume-Kendall and his associates.[11] These "highly suspicious" transactions included loans to companies intent on developing land in Cape Verde, the Dominican Republic[12] and Cornwall.[13] Hume-Kendall is a former chairman of the Tunbridge Wells Conservatives and donated £5,000 to Work and Pensions Secretary Amber Rudd. After the outbreak of the scandal, Rudd returned the money.

14. On 4 March 2019, four individuals connected with LCF were arrested and subsequently released pending further investigation by the Serious Fraud Office (SFO). The inquiries have also been joined by the National Crime Agency, HMRC, the City of London Police, the Crown Prosecution Service and the Home Office.

15. In March 2021, two further individuals[14] were questioned over the collapse of LCF. The current status of the inquiries is not known.

16. In September 2020, it was reported[15] that thirteen people including a former UK energy minister are being sued for £178m in connection with an alleged fraud at London Capital & Finance, where investors' cash is said to have been used to buy horses, a helicopter and lifetime memberships to Annabel's, the Mayfair private members' club. LCF invested £70 million of bondholders' money with a hotel property firm where two senior players now have fraud convictions[16].

17. On 19 March 2019, HMRC stated that the Innovative Finance ISAs offered to investors by LCF did not comply with the requirements of the ISA regulations. So how did the FCA supervise LCF?

REGULATORY FAILURES

[11] Daily Mail, Auditor Ernst & Young apparently missed 'highly suspicious' trades at collapsed investment firm London Capital & Finance before it went bust, 3 April 2019; https://www.thisismoney.co.uk/money/markets/article-6882839/Ernst-Young-apparently-missed-highly-suspicious-trades-London-Capital-Financet.html

[12] Financial Times, Scandal-hit London Capital & Financial was technically insolvent in 2017, 29 March 2019; https://www.ft.com/content/09df4f72-5222-11e9-9c76-bf4a0ce37d49

[13] Evening Standard, London Capital & Finance scandal widens as two new groups of pensioners fear for their savings, 10 July 2019; https://www.standard.co.uk/business/revealed-more-pensioners-fear-losses-from-lcf-projects-a4186766.html

[14] https://www.standard.co.uk/business/london-capital-finance-collapse-serious-fraud-office-sfo-b921868.html

[15] https://www.ft.com/content/93dd8947-3188-4510-adbc-95b1c1549eb6

[16] https://www.standard.co.uk/business/london-capital-finance-lcf-fraudsters-lakeview-cornwall-fraud-sfo-b936592.html

18. The FCA saw no problems at LCF even though it was selling mini-bonds within an ISA wrapper, which did not meet the rules.

19. When contacted by worried investors about rumours of frauds and poor investments, the FCA incorrectly told them that their investment was protected by the Financial Services Compensation Scheme (FSCS)[17].

20. On 2 April 2019, the FCA wrote to the Treasury Committee to state that it has commenced an investigation into its supervision of LCF, and whether the existing regulatory system adequately protects retail purchasers of mini-bonds from unacceptable levels of harm.

21. It should be noted there have been a number of scandals about the sale of mini-bonds which should have alerted the FCA to take decisive action. Here are some examples.

    a. Blackmore Bond PLC[18] began as a small company in 2016 and had share capital of £50,000[19]. It issued mini-bonds between 2016 and 2019 to raise money to develop properties. Investors were promised returns between 6.5% and 10%. The essential business model was that Blackmore would receive the money, lend it to a Special Purpose Vehicle (SPV) which in turn would buy and develop the properties. Blackmore and the SPV were also able to raise additional money by taking out loans and giving them security that ranked ahead of the bondholders.

    The company's first set of accounts for the period 12 July 2016 to 31 December 2017 showed a loss of £7,624,631. The company was technically insolvent and had a negative equity. Auditors Grant Thornton drew attention to note 1 to the accounts in which directors explained going concern uncertainties but did not qualify the accounts. The accounts showed that other than two directors and a chairman (appointed 1 November 2017), the company had no employees. These were the only accounts ever filed by Blackmore at Companies House.

    Investors received nothing since October 2019. Blackmore collapsed into administration in April 2020, when the company had only £906 cash at bank. This was followed by the appointment of a liquidator on 22 April 2021. The administrator's statement showed that by December 2018, the cumulative losses had mounted to over £15m. The information published by the administrator and accounts show that Blackmore collected £46m from investors, from which it paid out at least £9.3m in management and marketing fees. The company also took out a series of mortgages against its properties, most of which remain undeveloped. Blackmore's 2017 accounts – the only ones it publicly filed – show that the company paid 20

[17] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/945247/Gloster_Report_FINAL.pdf
[18] https://www.independent.co.uk/news/business/news/blackmore-bond-collapse-administration-investment-scam-minibonds-a9489921.html
[19] https://find-and-update.company-information.service.gov.uk/company/10273135

per cent commission to sales agents for signing-up investors. The business model required Blackmore to generate at least a 25% return before any profits would be available to pay investors. Concerns about Blackmore's operations were expressed to the FCA in March 2017 but it did nothing. The administrators say that they may be able to recover just £1m or the £46m invested. Savers are expected to lose almost all of their money[20]. HMRC is owed nearly £500,000 and is an unsecured creditor.

At the date of administration, Blackmore had only two employees. These were its directors Philip Nunn and Patrick McCreesh.

It should be noted that the marketing of the mini-bonds falls within the Financial Promotions Regime. This means that while the product itself is unregulated, the marketing of the product needs to be made or approved by someone who is authorised by the FCA. Through this the FCA has the ability to enforce its rules to ensure that such promotions are (for example) fair, clear and not misleading. Blackmore used a marketing agency, Amyma Ltd (Amyma), to promote its bonds. Amyma was an "appointed representative" of an FCA-authorised firm, allowing it to carry out regulated activities as an agent of another firm. Amyma particularly targeted pensioners and unsophisticated investors and used high-pressure sales tactics to sell mini-bonds[21].

It has been reported that the FCA was warned by the police on 45 occasions about suspicious activity at "mini-bond" provider Blackmore[22]. The police first alerted the FCA to suspect behaviour at Blackmore in November 2018.

By April 2021 administrator and legal fees relating to Blackmore's insolvency had exceeded £1.8 million

b. Basset & Gold[23] is another mini-bond scandal. During 2016 to 2019, the company enticed investors by offering 4.24% return and likened its mini-bonds to cash savings products previously offered to pensioners by National Savings & Investments. Some 1,800 investors invested £35 million and were told money would be used to back small businesses, but almost all of it ended up in a payday loan firm called Uncle Buck, with another £100,000 put into a peer-to-peer property financing platform. On 1st April 2020, the company entered administration and administrators say that savers are likely to lose all of their investment. So far, the Financial Services Compensation Scheme has handed compensation payouts worth

[20] https://www.independent.co.uk/news/business/blackmore-minibond-savers-money-b1760433.html
[21] https://www.independent.co.uk/news/business/news/blackmore-bond-collapse-administration-investment-scam-minibonds-a9489921.html
[22] https://www.telegraph.co.uk/investing/bonds/city-watchdog-ignores-45-warnings-investors-lose-47m-bond-scandal/
[23] https://www.thisismoney.co.uk/money/investing/article-9500091/Basset-Gold-170-mini-bond-investors-wait-Financial-Ombudsman-ruling.html

£17million to 950 investors for mis-selling found to have taken place after March 2018.

c. In 2018 Mexican food chain Chilango[24] issued a mini-bond offering 8% return as well as a number of perks, including free burritos, to fund its business activities. More than 1,000 people bought £5.8m of its mini-bonds. The investments were dubbed "burrito bonds" because if you invested more than £10,000 you could claim one free burrito a week. In July 2020, the company entered administration and investors are expected to lose 90-99% of their investment[25].

d. In 2013 Secured Energy Bonds raised £7.5 million from 937 investors promising returns of 6.5% per annum. In 2015, administrators were appointed. The FSCS has paid out around £5million in compensation to roughly 500 investors[26].

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22. After a long list of mini-bond scandals, in January 2020, the FCA introduced a temporary ban on the sale of mini-bonds[27]. In June 2020, the ban was made permanent[28] and applies to all adverts for unlisted and illiquid bonds. The rationale was that "speculative mini-bonds were being promoted to retail investors who neither understood the risks involved, nor could afford the potential financial losses". Why the delay in recognising this? Why did the FCA not road-test financial products sold to the public. He alarm bells were ringing long before it acted.

    Just ahead of the Bill (May 2021), the FCA, HMRC and Treasury set-up an Isa-focused working group and claim to have removed 30 firms from HMRC's Isa manager register because they failed to meet the rules[29].

23. At the time of the ban on sales of mini-bonds, the outstanding amount invested in so-called speculative illiquid securities, which includes mini-bonds and similar preference shares, was about £1.4 billion. The FCA[30] believes that there were more than 63,500 bondholders with an average of £22,100 invested before the temporary marketing ban came in. So the mini-bond scandal could be much bigger than the LCF.

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24 https://moneyweek.com/investments/bonds/corporate-bonds/601733/how-investors-got-burned-by-chilangos-burrito-bonds

25 https://www.theguardian.com/money/2019/dec/14/chilango-burrito-bond-investors-could-lose-90-of-their-cash

26 https://www.thisismoney.co.uk/money/investing/article-7447777/SEB-mini-bond-investors-win-5m-payout-FSCS.html

27 https://www.fca.org.uk/publications/temporary-product-interventions/temporary-intervention-marketing-speculative-mini-bonds-retail-investors

28 https://www.fca.org.uk/news/press-releases/fca-make-mini-bond-marketing-ban-permanent

29 https://www.ftadviser.com/regulation/2021/05/11/fca-creates-isa-working-group-in-response-to-mini-bond-scandal/

30 https://www.fca.org.uk/publication/consultation/cp20-8.pdf

24. In December 2020, Dame Elizabeth Gloster's report[31] on the collapse of LCF was published and it was highly critical of the FCA. For example, it described the FCA's supervision of LCF as "wholly deficient"; and that there were "significant gaps and weaknesses" in the FCA's policies and practices. Its staff had "not been trained sufficiently to analyse a firm's financial information to detect indicators of fraud or other serious irregularity".

25. The report's remit explicitly excluded the question of compensation but nevertheless it highlighted regulatory failures and led to demands for compensation.

26. In April 2021,the government issued a consultation paper[32] on the possibility of binging the issuance of non-transferable debt securities ('mini-bonds') within the scope of financial services regulation. The consultation period ended on 21 July 2021. The next steps are not known.

LCF COMPENSATION SCHEME

27. In March 2021, following a judicial review application by the investors, in the case of *Donegan & Ors, R (On the Application Of) v Financial Services Compensation Scheme Ltd [2021] EWHC 760 (Admin) (29 March 2021),* the High Court[33] held that the mini-bonds purchased from LCF were not transferable securities and as a result most investors were not eligible for Financial Services Compensation Scheme (FSCS) protection.

28. The Gloster Report and the FCA's failures fuelled demands for a compensation scheme.

29. The precedence for compensation is perhaps provided by the case of Equitable Life[34] which collapsed in 2000 and Barlow Clowes which collapsed in 1988[35]. Both had offered guaranteed high or risk-free returns which proved to be impossible to honour. Equitable Life adopted a series of legal and economic measures to reduce payments to its policyholders and led to a backlash. Barlow Clowes was engaged in frauds.

30. On 19 April 2021, the government announced a compensation scheme[36]. It said that:

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[31]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/945247/Gloster_Report_FINAL.pdf
[32] https://www.gov.uk/government/consultations/regulation-of-non-transferable-debt-securities-mini-bonds-a-consultation
[33] https://www.bailii.org/ew/cases/EWHC/Admin/2021/760.html
[34] https://www.bbc.co.uk/news/business-10725923; also see https://commonslibrary.parliament.uk/research-briefings/cdp-2017-0097/
[35] https://api.parliament.uk/historic-hansard/commons/1989/dec/19/barlow-clowes
[36] https://www.gov.uk/government/news/details-of-compensation-scheme-for-london-capital-finance-bond-holders-announced

“Due to the unique and exceptional nature of the situation concerning London Capital & Finance (LCF), the government will establish a scheme that provides 80% of LCF bondholders’ initial investment up to a maximum of £68,000”.

“The scheme will be available to all LCF bondholders who have not already received compensation from the Financial Services Compensation Scheme (FSCS) and represents 80% of the compensation they could have received had they been eligible for FSCS protection, which is capped at £85,000”.

31. The proposed scheme expects to pay out around £120m compensation[37] to around 8,800 people in total.

32. Around 97% of all LCF bondholders invested less than £85k and therefore will not reach the compensation cap under either the government scheme or the FSCS.

33. Separately to the scheme the FSCS has already paid out £57.6m in redress for customers which it believes had bad advice but has stopped short of further payments. Since February 2020, the FSCS has paid compensation to over 2,871 bondholders.

34. This compensation is also restricted to £85,000 and many LCF investors had invested greater amounts. They are pursuing the legal case for further compensation from the FSCS . A lawyer said[38]: “This appeal relates to the FSCS’s decision not to compensate more investors in LCF under the usual FSCS rules – to which the 80 per cent haircut in the government scheme would not apply. The judicial review remains relevant – it concerns over £20m across LCF investors as a whole, as well as being of considerable interest to taxpayers”. Subsequently, the appeal has been dropped[39].

THE BILL

35. The Bill was introduced in the House of Commons on 12 May 2021 and implements the above compensation scheme. It has two purposes.

    a. It establishes a compensation scheme for customers of London Capital & Finance plc (“LCF” and the “Compensation Scheme”

    b. It changes the Pensions Act 2004 to allow for loans to be made to the Board of the Pension Protection Fund (PPF) for the purpose of its fraud compensation functions.

[37] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/978362/WMS_-_LCF_CS_-_final__003_.pdf
[38] https://www.p2pfinancenews.co.uk/2021/05/12/fscs-to-administer-120m-treasury-lcf-compensation-scheme/
[39] https://www.ftadviser.com/investments/2021/08/24/lcf-investors-drop-appeal-against-fscs/

The Fraud Compensation Fund ('FCF') was set up under the Pensions Act 2004 and is run by the Board of the Pension Protection Fund. The FCF pays compensation to trustees or scheme managers of most occupational pension schemes whose employers become insolvent in circumstances where the scheme has lost out financially due to offences involving dishonesty. This compensation is paid for through a levy on both defined benefit, e.g. final salary, and defined contribution, e.g. money purchase, pension schemes.

36. The Bill allows HM Treasury to incur expenditure by establishing a compensation scheme for customers of LCF who have been affected by the circumstances identified in the Gloster Report. Part 15A of the Financial Services and Markets Act 2000 ("FSMA") will be used to require the FSCS to administer the compensation scheme on behalf of and at the direction of HM Treasury.

37. When the FSCS is required to administer a compensation scheme under Part 15A FSMA, the FCA may use its powers under section 224F(5) FSMA to make rules in relation to that scheme. Ordinarily, under section 138I FSMA, the FCA is required to undertake a full public consultation and impact assessment before making any such rules. However, the Bill disapplies section 138I, removing the requirement on the FCA to undertake public consultation.

38. Re Loans to PPF – In November 2020 the High Court confirmed in the case of *Board of the Pension Protection Fund v Dalriada Trustees Ltd*[40] that members of certain types of pension scams that relate to pensions liberation are eligible for compensation from the FCF. As a result of this decision, the PPF has estimated that there will be compensation in the region of £350 million payable (there are also other cases). Even with its expected future levy income, the PPF will have underfunded liabilities of between £200 million to £250 million.

39. Clause 2 of the Bill creates empowers HM Treasury a power to make a loan to the board of the PPF, following the decision of 6 November 2020 in the case of the PPF v. Dalriada. The loan becomes necessary because in 2019/20 Fraud Compensation Fund had assets of only £21.5 million[41] whilst facing claims of £350 million. Inevitably, the levy on pension schemes will need to rise. At the time of the court judgment, the FCA had assets of around £26.2 million[42].

40. The loan will be made on terms that the Secretary of State determines. Section 115 of the Pensions Act is amended so that the borrowing cap referred to only applies to loans granted under that section and not to loans issued under section 115A.

41. Finally, section 188(1) of the Pensions Act is amended so that the contents of the FCF include money borrowed under section 115A and the repayment of that

[40] https://www.bailii.org/ew/cases/EWHC/Ch/2020/2960.html
[41] https://www.ppf.co.uk/about-us/what-we-do/fraud-compensation-fund
[42] https://bills.parliament.uk/publications/41484/documents/211; also see page 139 https://www.ppf.co.uk/sites/default/files/2020-10/PPF_AR_13102020.pdf

money to the Secretary of State is included as a permitted payment from the fund.

SOME ISSUES

42. The Bill enables HM Treasury to set-up the compensation scheme, but that is not the end of legal battles. A number of things should be noted.

    a. Many innocent LCF investors face losses as the compensation is capped at £68,000. Therefore, many retirees will face financial insecurity. The government's rationale is that compensation through the Financial Services Compensation Fund is capped at 80% (£85,000 x 80%). But the point is that there is regulatory failure and the burden falling on individuals is also disproportionate i.e. it is higher for those with less wealth. There are also gender effects as women often have less wealth.

       Some people had invested more than £85,000 and they stand to lose an even bigger amount and are taking legal action.

    b. The government is paying compensation to LCF investors. What about investors in Blackmore, Bassett and Gold, Secured Energy Bonds and elsewhere? As noted above, some £1.4 billion of investment could be trapped or lost due to frauds and misrepresentation.

    c. Why no compensation in on other cases of FCA failures? Here are a few examples:

       An independent report on the collapse of Connaught[43] also stated that the FSA/FCA supervision was "not appropriate or effective" and it could have done more to protect consumers. The investors lost over £100m but received £18.5m through litigation[44].

       In November 2017, the FCA ordered[45] that Capita Financial Managers Limited (CFM) pay up to £66 million to those investors who suffered loss as a result of investing in the Guaranteed Low Risk Income Fund.

       In December 2020, the FCA ordered Blue Gate Capital Limited[46] pay £203,007 to investors. That still leaves investors millions out of pocket. No compensation has been offered for the regulatory failures of the FCA, which is a key reason for the LCF compensation scheme.

       The collapse of LCF was investigated (The Gloster Report) but why no investigation of other mini-bond scandals. It may be argued that other

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[43] https://www.fca.org.uk/publication/corporate/connaught-independent-review.pdf
[44] https://www.fca.org.uk/publication/final-notices/capita-financial-managers-limited-2017.pdf
[45] https://www.fca.org.uk/news/press-releases/capita-financial-managers-pay-66-million-benefit-investors-connaught-income-fund-series-1
[46] https://www.fca.org.uk/news/press-releases/blue-gate-capital-limited-ordered-pay-connaught-investors

scandals were smaller, but that does not mean that the pain for people is less.

Neil Woodford's Equity Income fund collapsed in the summer of 2019, it left a lot of small investors out of pocket[47]. The FCA has also been negligent in its supervision, but no compensation has been offered.

The long-running frauds at the Global Restructuring Group (GRG) of Royal Bank of Scotland (RBS) started around 2007 and still not resolved and victims not fully compensated. In February 2018, the House of Commons Treasury Committee published the report that the FCA would not and said[48]: "The findings in the report are disgraceful. The overarching priority at all levels of GRG was not the health and strength of customers, but the generation of income for RBS, through made-up fees, high interest rates, and the acquisition of equity and property". Under pressure, the FCA published its final report[49] in June 2019. Kevin Hollinrake MP said[50]: "This report is another complete whitewash and another demonstrable failure of the regulator to perform its role. Phase 2 of the FCA's own Final Requirement Notice was supposed to "consider the root causes" and establish whether "the causes of such treatment were known about, authorised by and/or sanctioned by management within RBS Group". They have manifestly failed to do this".

Fraudulent trading, corruption and money laundering were the hallmarks of HBOS frauds and go back to nearly 20 years. The government is content to leave the matter to Lloyds Bank, which took over HBOS, and it has excelled at obfuscation and delay. The report by Dame Linda Dobbs is once again delayed[51] and victims of frauds are still awaiting compensation.

d. The LCF compensation is being paid through the FCF but so far 'fraud' has not been established. There has bene no court case and no convictions.

e. The government says the LCF compensation scheme is due to "unique and exceptional nature". Was it the regulatory failures, frauds, audit silence or something else? This point should be probed. All of the failures are also applicable to other cases of mini-bonds identified in this briefing.

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[47] https://www.moneymarketing.co.uk/analysis/whos-to-blame-for-woodford-collapse/; https://www.ftadviser.com/investments/2021/08/02/close-to-124m-still-trapped-in-woodford-fund/

[48] https://committees.parliament.uk/committee/158/treasury-committee/news/98862/treasury-committee-publishes-rbsgrg-report/

[49] https://www.fca.org.uk/publication/corporate/fca-report-further-investigation-rbs-grg.pdf

[50] https://www.financialreporter.co.uk/regulation/mps-slam-fcas-whitewash-final-report-into-rbs-grg-scandal.html

[51] https://www.thetimes.co.uk/article/report-into-lloyds-fraud-cover-up-is-delayed-again-b8rhvr98z

On 21 April 2021, John Glen MP, Economic Secretary to the Treasury said this to the House of Commons Treasury Committee[52]:

"There are three broad reasons. The first is the business model of LCF and the scale and structure of what was going on. There are also issues around LCF being the only failed minibonds for which the FCA authorisation failed where on-lending was involved, so people were essentially buying a financial instrument and product where the underlying assets were lent on through another entity. The third factor I had to weigh up was the halo effect of a firm being authorised but conducting unregulated activity.

We looked at the 30 minibond firms that have failed over the last six to seven years, and we looked at the range of issues involved. Given the authority and depth of Dame Elizabeth Gloster's report, we concluded—I concluded—that this compensation scheme is appropriate. I then had to weigh up the nature of the obligation and weigh up the obligation to the taxpayer. We have come up with a scheme that gives people 80% of their losses, up to the £85,000 of the FSCS compensation limit. That will mean that 97% will get 80% of their original investment back. That is the context and description of what I have agreed".

The above still does not explain why the compensation offered to LCF investors is not available to other victims of the sale of mini-bonds.

f. The FSCS compensation is effectively paid out of levies made on better run investment businesses i.e. honest businesses bear the cost of the dishonest ones. There is clearly a moral hazard as miscreants can fleece people and then dump liability to the FSCS.

g. Ordinary people will bear the cost of the £120m LCF compensation. To operationalise the compensations scheme, HM Treasury will lend £120m to the FCF via the Pension Protection Fund (PPF). So initially, the loan will effectively be from taxpayers.

   The government expects that the loan would be repaid by the FCF levy over a period currently estimated to be between 10 and 15 years. So the net result is that the £120m will come out of the pockets of solvent pension schemes and their members. The FCF levy is collected by The Pension Regulator (TPR) on behalf of the PPF Board. The costs of administering the FCF is borne by the PPF Administration Fund and then allocated to FCF.

h. Can the £120m loan actually be repaid in 10-15 years? The annual accounts[53] show that the FCF levy for the year to 31 March 2019 was £4.8m and rose to £6.9m for 2020. Yet the government is expecting a repayment of £120m plus interest (?) in 10-15 years. Is that possible?

[52] https://committees.parliament.uk/oralevidence/2074/html/
[53] https://www.ppf.co.uk/sites/default/files/2020-10/PPF_AR_13102020.pdf

The FCF levy would need to nearly double just to pay the loan. Of courses, there are other demands on the FCF too due to a variety of pension scams and that means even higher levies. A better policy would be for HM Treasury to bear the cost of £120m. After all, the FCA has been negligent.

In relation to potential liabilities of the FCF, page 136 of the PPF financial statement for the year to 31 March 2020[54] states:

> "The FCF has £21.5m (2019: £19.1m) of money market funds and provisions valued at £nil (2019: £nil). The Board has the power to raise levies to meet the cost of successful claims. The FCF is at risk of a large and urgent claim, or a number of such claims occurring closely together which would require prompt settlement. The Board is aware of the potential for significant claims with regard to schemes that were themselves part of a scam and seven applications have been received with an estimated total claim value of £43.6m. There remains uncertainty as to the eligibility of these claims and the total value of future applications expected. Additionally, the time required to assess new claims would allow the FCF to raise any further funding needed. However, the FCF faces a constraint in its ability to meet large claims. There is currently a limit of £25m set by statutory instrument on the Board's ability to raise funds".

i. It is worth noting that the FSCS is also funded by levies on investment firms and if it was required to pay compensations then it would have had to increase in levies on the finance industry. By shifting the compensations scheme to the PPF, the government has spared the finance industry and has penalised the pension schemes,

j. Despite the admission of regulatory failure, the FCA executives have not faced any consequences. Indeed, its chief executive Andrew Bailey is now the governor of the Bank of England.

k. In the era of low interest rates, what interest will HM Treasury charge on its loan to PPF/FCF?

l. There is no clawback of remuneration from any of the LCF executives. Some directors of LCF may be disqualified by the Insolvency Service but over two years later no action has yet been taken. Hardly a model of efficiency. Even if directors are disqualified they will keep their ill-gotten gains.

m. The SFO has arrested, interviewed and then released a number of people. Will anyone be prosecuted? The delay does not amount to swift action and SFO has a poor record of prosecutions.

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[54] https://www.ppf.co.uk/sites/default/files/2020-10/PPF_AR_13102020.pdf

n. In June 2020, the Financial Reporting Council[55] announced an investigation into the audits at LCF. If audits are found to be deficient, the most likely penalty will be a fine. Such fines (since 2016) will go to HM Treasury, and not to investors facing hardship caused by auditor silence. The fines for audit failures should be used to increase the return to innocent investors.

o. The LCF administration has been a nice little earner for administrators[56], lawyers and sundry advisers have chalked up a bill of £25m. More is expected and will deplete any funds which may have been available to unsecured creditors. The Insolvency Service takes no interest in the duration of liquidation/administration.

IN CONCLUSION

The LCF scandal is part of a long line of financial scandals: mis-selling and frauds. Despite the regularity of scandals large parts of the finance industry, including private equity and hedge funds, remain unregulated.

Within the current regulatory model, there are problems at the perimeter. LCF was supervised by the FCA but not for the sale of mini-bonds. Hence, the neglect of what happened at the perimeter. A simpler approach would be that all financial entities need to be regulated and all financial products must be tested for the capacity to cause harm, but such policies are not on the government's radar.

Inquiries, such as the Gloster inquiry, are helpful but they individualise failures, frauds and fiddles. Problems are attributed to weak and failing individuals or rotten apples. Systemic problems, such as pressures for high returns, short-termism, directors' powers and accountability, corporate culture, neglect of stakeholders and cognitive capture of regulators continue to be neglected.

The state, much maligned by neoliberals, has once again had to intervene to clear up the mess created by the finance industry. However, the regulatory failures have not been accompanied by regulatory reforms. The FCA's structure remains unchanged. It will not have a Supervisory Board of stakeholders to oversee the conduct of its executives. There is no independent inquiry (Australia had a Royal Commission) into the operations of the finance industry.

The state's indulgence of the finance industry will inevitably lead to more financial scandals, especially as entrepreneurs know that the mess will be cleared by the state.

[55] https://www.frc.org.uk/news/june-2020/frc-launches-investigations-into-three-audit-firms
[56] https://www.thetimes.co.uk/article/london-capital-amp-finance-administration-costs-reach-25m-w8rvpnvj6