The market for securitised derivatives in the UK, although growing, has not yet achieved the volumes seen in other European jurisdictions. Neel Sachdev looks at the regime governing the market in the City

# Underlying benefits


In October 2002, the Financial Services Authority (FSA) launched the UK market in listed securitised derivatives. These are available to private investors as retail securitised derivatives and professional investors as specialist securitised derivatives.

Securitised derivatives encompass three broad types of product: covered warrants, certificates and structured products. Covered warrants are securities that have similar economics to options in that they confer on the holder the right to buy or sell a certain underlying asset at a particular price within a specified timeframe. Certificates are securities, but unlike warrants they have no leverage; in other words, their price tracks the performance of the underlying assets directly.

The final category of structured products contains securitised derivatives that have more complex features. These features include custom baskets of shares as an underlying and 'turbo warrants' (warrants that can be terminated early in the event that certain pre-agreed levels are reached).

The regulatory regime governing the securitised derivatives market was implemented by a new Chapter 24 of the Listing Rules. Corresponding changes were also made to the FSA's Conduct of Business Sourcebook.

The rules in Chapter 24 cover "an option or a contract for differences or a debt security with characteristics of either an option or a contract for differences or both". An issuer seeking to list securitised derivatives must either be a bank or securities firm with permission under the Financial Services and Markets Act 2000 to issue such securities, or an overseas firm approved by its home state regulator (with a lead regulation agreement with the FSA) to issue relevant securities, or any other entity with a guarantee of its obligations from such an approved bank, securities firm or overseas firm.

The underlying instrument must be traded on a regulated, regularly operating, recognised open market, unless it is a currency, an index, an interest rate or a basket of any of these instruments. Examples of underlying instruments to date include instruments as diverse as property prices, futures contracts, commodities and Chinese equities.

The directors of an issuer of retail securitised derivatives must take personal responsibility for the contents of the listing particulars delivered in connection with the issuance or the relevant programme, whereas for an issuer of specialist securitised derivatives, the veil of corporate responsibility is not pierced.

As one would expect, the disclosure requirements and (as mentioned above) the degree of responsibility for listing particulars that must be assumed is much more stringent when securitised derivatives are sold to private investors. In addition, the terms and conditions of retail securitised derivatives must contain inherent protection for private investors. These include prohibitions on contingent liability terms requiring the investor to make any further payments.

The securitised derivatives market in a number of other European jurisdictions is much more developed than in the UK. In Europe, the big three jurisdictions are Germany, Italy and Switzerland, where the combined monthly premium turnover in securitised derivatives has on occasion reached €7bn (£4.7bn). A relatively small average trade size reflects the fact that the majority of this activity originates from private clients rather than institutions. Recent data shows that the premium turnover in Italy has reached €20bn (£13.3bn) per year. The projected premium turnover in the UK for the year to date is approximately €230m (£153m).

The UK market has aped many features from the main European markets; for example, its products are listed and traded on the domestic stock exchange, settled through the existing equity settlement system (CREST), and it permits issuers to launch new warrants within 24 to 48 hours. This makes it one of the fastest to-launch markets in Europe. However, the UK market has failed to replicate the success of the main European markets and has not seen the growth levels anticipated at the market's birth. This is a result of a combination of legal and market issues.

As described above, the directors of an issuer of retail securitised derivatives accept personal responsibility for the information contained in the listing particulars. This level of responsibility has been an obvious disincentive for new issuers to enter the market. Although it is possible to structure the issuer as a special purpose vehicle (SPV), the issuer must be guaranteed by a bank or financial institution. Many banks and financial institutions have been reluctant to guarantee the obligations of an SPV in this way.

The market has suffered from a lack of clarity in relation to the application of the financial promotion regime in the FSA's Conduct of Business Rules to firms selling retail securitised derivatives. A communication by a firm inviting a private customer to purchase retail securitised derivatives will constitute a direct offer financial promotion. COB3.9.5R provides that a direct offer financial promotion must not relate to a warrant or a derivative unless the firm itself has adequate evidence to suggest that the investment may be suitable for the person to whom the promotion is communicated. Issuers and brokers have been unclear what degree of information relating to retail securitised derivatives posted on websites would constitute a direct offer financial promotion. The FSA has not provided issuers and brokers with general guidance on these issues.

However, brokers selling securitised derivatives over the internet must comply with the suitability requirements of COB3.9.5R. It has been unclear how brokers can discharge the suitability requirements in the COB if they are selling on the internet on an execution-only basis. The FSA has confirmed that it will give case-by-case guidance on how to discharge the suitability requirements, and it has been suggested that a firm can satisfy itself as to the suitability of an investor through online self-certification testing (in essence a risk warning requiring the retail investor to confirm its understanding and acceptance of the risks associated with the retail securitised derivatives in question). There remain considerable uncertainties concerning the frequency and scope of testing, as well as the retention of records required to discharge a firm's obligations in relation to an investor's suitability. This uncertainty, along with the fact that the spread betting market is not subject to these same regulatory requirements, is perceived to have fettered the growth of the market.

Retail investors are likely to get capital gains tax treatment for their transactions in retail securitised derivatives. Because they are listed, investors will not suffer any erosion of their tax base cost on option type products in the period up to exercise, expiry or abandonment, unlike unquoted options. However, the retail investor probably pays no tax on spread betting gains. That would be a better net position if spread betting is genuinely no more risky than buying a securitised derivative.

At its inception, the UK market for listed retail securitised derivatives was touted as a new weapon to fight bear markets and was expected to expand private investors' horizons. The current range of products on the market gives private investors the opportunity to hedge their portfolios, protect against property market crashes or speculate on a non-margin basis, with their liability limited to their original investment. The market has run into some difficulties, but these do not appear insurmountable. The flexibility of the underlying product means these investments are still likely in due course to become an integral part of the wily investor's repertoire.

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