FSA 2002/37

SECURITISED DERIVATIVES CONDUCT OF BUSINESS INSTRUMENT 2002

Powers exercised

A. The Financial Services Authority amends the Conduct of Business sourcebook and the Glossary in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (the "Act"):

(1) section 138 (General rule-making power);

(2) section 149 (Evidential provisions);

(3) section 156 (General supplementary powers); and

(4) section 157 (1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) of the Act (Rule-making instruments).

Commencement

C. This instrument comes into force on 1 August 2002.

Amendments to the Conduct of Business sourcebook and the Glossary

D. The Conduct of Business sourcebook is amended in accordance with Annex A to this instrument.

E. The Glossary is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Securitised Derivatives Conduct of Business Instrument 2002.

By order of the Board
20 June 2002

Annex A

Amendments to the Conduct of Business sourcebook

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

COB 5.4.3A	G	A *securitised derivative* (as defined in the *Glossary*) is a *derivative* and *COB rules* relevant to *derivatives* therefore apply. *Firms* should note that the *Glossary* definition of *securitised derivative* is slightly different from the definition in chapter 24 of the *listing rules*. An instrument *listed* under that chapter, which is not an *option* or *contract for differences*, is not a *securitised derivative* for the purposes of *COB*.
COB 5.4.4	E	The reasonable steps in *COB* 5.4.3 R should include the steps set out in *COB* 5.4.6 E to *COB* 5.4.10 E as appropriate, in relation to transactions in the following types of investment or activity: (1) *warrants* and *derivatives* (see *COB* 5.4.6E, *COB* 5.4.6A E or *COB* 5.4.6C E as appropriate); (2) *non-readily realisable investments* (see *COB* 5.4.7E); (3) *penny shares* (see *COB* 5.4.8E); (4) *securities* subject to stabilisation (see *COB* 5.4.9E); (5) *stock lending activity* (see *COB* 5.4.10E).
		Risk warnings in respect of warrants and derivatives (other than retail securitised derivatives and certain EEA listed derivatives)
COB 5.4.6	E	(1) In relation to a transaction in a *warrant* or *derivative* (other than a *retail securitised derivative* or an *option* or *contract for differences* to which *COB* 5.4.6C E applies), the *firm* should: (a) provide the *private customer* with the notice in *COB* 5 Ann 1E (Warrants and derivatives risk warning notice); and (b) require the *private customer* to acknowledge receipt of the notice and confirm acceptance of its contents, in writing. (2) A *firm* need not undertake steps *COB* 5.4.6 E (1) (a) and (b) in respect of a *private customer* who is ordinarily resident outside the *United Kingdom*, if it has taken reasonable steps to determine that the *private customer* does not wish to receive the notice.

(3) The notice in *COB* 5 Ann 1E (Warrants and derivatives risk warning notice) need not be sent in relation to the realisation of a *warrant* that is already held by the *private customer*, or of a *warrant* attached to another *designated investment*.

Risk warnings in respect of retail securitised derivatives

COB 5.4.6A E (1) In relation to a transaction in a *retail securitised derivative*, the *firm* should provide the *private customer* with:

(a) the notice in *COB* 5 Ann 1E (Warrants and derivatives risk warning notice); or

(b) a copy of the listing particulars prepared for the *securitised derivative* in accordance with chapter 24 of the *listing rules*, in a manner calculated to bring to the attention of the *private customer* the description of risk factors required by paragraphs 24.36 and 24.37 of the *listing rules* (Disclosure about risk factors); or

(c) a notice containing a clear, fair and adequate description of the *securitised derivative* which is to be the subject of the transaction, in a manner calculated to bring to the attention of the *private customer* the risks involved, in particular (and if applicable):

(i) that the *securitised derivative* gives rise to risks similar to those arising when an investor buys or sells an *option*;

(ii) that the *securitised derivative* is 'geared' or 'leveraged', which means that a relatively small movement in the price of the underlying instrument, whether favourable or adverse, could result in a larger movement in the price of the *securitised derivative*;

(iii) that the price of the *securitised derivative* may therefore be volatile;

(iv) that the *securitised derivative* has a limited life, and may expire worthless if the underlying instrument (such as a *share* or index) does not perform as expected;

(v) that, consequently, the *private customer* should not enter into the transaction unless he is prepared to lose all of the money he has invested, plus any *commission* or other *charges*;

(vi) that the *private customer* should satisfy himself that the *securitised derivative* is suitable for him, in the light of his circumstances and financial position, and if the *private customer* is in any doubt he should seek professional advice; and

(vii) a clear, fair and adequate description of any other relevant risks affecting the value, trading price, and realisation of the value of the *securitised derivative*.

(2) A *firm* should either:

(a) require the *private customer* to acknowledge receipt of the document provided in accordance with (1)(a), (b) or (c) and confirm acceptance of its contents, in writing; or

(b) be otherwise able to demonstrate that the *private customer* has received the document and had a proper opportunity to consider its terms.

(3) A *firm* need not undertake steps (1) and (2) in respect of a *private customer* who is ordinarily resident outside the *United Kingdom*, if it has taken reasonable steps to determine that the *private customer* does not wish to receive the notice.

COB 5.4.6B G (1) It is appropriate for a notice provided to a *private customer* in accordance with *COB* 5.4.6A E (1)(c) to explain, where applicable, the existence and extent of any factors that reduce the risks to which the *private customer* is exposed (for example, the fact that the *securitised derivative* is *listed*, or subject to some form of guarantee), but the *firm* should ensure that any such statement does not disguise, obscure or diminish the significance of the notice taken as a whole.

(2) The document provided to a *private customer* in accordance with *COB* 5.4.6A E (1)(b) or (c) may use another term (such as 'covered warrant') to describe a *securitised derivative*, if it is generally accepted market practice to do so.

(3) In relation to (1) and (2), *firms* are also reminded of the requirements of *COB* 2.1 (Clear, fair and not misleading communication).

Risk warnings in respect of certain derivatives listed in other EEA States

COB 5.4.6C E In relation to an *option* or *contract for differences* which is included on the *official list* of an *EEA State* other than the *United Kingdom*, a *firm* should comply with *COB* 5.4.6A E if:

(1) the *investment* is not a *contingent liability investment*; and

(2) (if it provides a right of exercise) the *investment* would comply with paragraph 24.7 of the *listing rules* (Method of exercising retail securitised derivatives), if it were listed on the *UK official list*.

COB 5 Ann 1E 1 Table This table belongs to COB 5.4.6 E

This notice is provided … you should be aware of the following points. (Include or delete as appropriate).

1. Warrants

A warrant … transaction charges.

~~Some other instruments are also called warrants but are actually options (for example, a right to acquire securities which is exercisable against someone other than the original issuer of the securities, often called a 'covered warrant').~~

2 Off-exchange warrant transactions

Transactions in … risks involved.

3 Securitised derivatives

These instruments may give you [a time-limited right (Note 1)] [an absolute right (Note 2)] to acquire or sell one or more types of investment which is normally exercisable against someone other than the issuer of that investment. Or they may give you rights under a contract for differences which allow for speculation on fluctuations in the value of the property of any description or an index, such as the FTSE 100 index. In both cases, the investment or property may be referred to as the "underlying instrument".

These instruments often involve a high degree of gearing or leverage, so that a relatively small movement in the price of the underlying investment results in a much larger movement, unfavourable or favourable, in the price of the instrument. The price of these instruments can therefore be volatile.

These instruments have a limited life, and may (unless there is some form of guaranteed return to the amount you are investing in the product) expire worthless if the underlying instrument does not perform as expected.

You should only buy this product if you are prepared to sustain a [total loss (Note 3)] [substantial loss (Note 4)] [loss (Note 5)] of the money you have invested plus any commission or other transaction charges.

You should consider carefully whether or not this product is suitable for you in light of your circumstances and financial position, and if in any doubt please seek professional advice.

Notes (these notes are not part of the notice):

1 Use for instruments such as covered warrants where there is some form of exercise required by the investor.

2 Use for instruments such as linked notes, or some certificates where there is some no form of exercise required by the investor.

3 Use for instruments such as covered warrants where the return payable to the investor is totally dependant upon the performance of the underlying instrument/s to which the product is linked and there is not another form of payment due to the investor (for example the repayment of capital).

4 Use for instruments such as linked notes where there is a form of return paid to the investor irrespective of the performance of the underlying instrument/s to which the product is linked, but the return is low.

5 Use for instruments such as linked notes where there is a form of return paid to the investor irrespective of the performance of the underlying instrument/s to which the product is linked, but the return is high but less than 100% of the amount paid for the product.

~~3~~4. Futures

Transactions in .. as well as for you. Futures transactions have a contingent liability, and you should be aware of the implications of this, in particular the margining requirements, which are set out in paragraph ~~8~~ 9.

~~4~~5. Options

There are …

~~5~~6. Contracts for differences

Futures and options contracts can also be referred to as contracts for differences. These can be options and futures on the FTSE 100 index or any other index, as well as currency and interest rate swaps. However, unlike other futures and options, these contracts can only be settled in cash. Investing in a contract for differences carries the same risks as investing in a future or an option and you should be aware of these as set out in paragraphs ~~3~~4 and ~~4~~ 5 respectively. Transactions in contracts for differences may also have a contingent liability and you should be aware of the implications of this as set out in paragraph ~~8~~ 9.

~~6~~7. Off-exchange transactions in derivatives

It may…

~~7~~8. Foreign markets

Foreign markets …

~~8~~9. Contingent liability investment transactions

Contingent liability …

~~9~~10. Limited liability transactions

Before entering …

~~10~~11. Collateral

If you …

~~11~~12. Commissions

Before you …

~~12~~13. Suspensions of trading

Under certain …

~~13~~14. Clearing house protections

On many …

~~14~~15. Insolvency

Your firm's …

[name of firm]

[on duplicate for signature by private customer]

I/We have read and understood the risk warning set out above.

Date

[Signature of the customer]

[Signature of joint account holder]

Note to firms

Paragraphs 1-~~10~~15 may be deleted when they relate to particular kinds of business which will not be carried out with or for the customer.

~~Paragraphs 11-14 are mandatory and may not be deleted.~~

This notice may be incorporated as part of a two-way customer agreement, but the customer must sign separately that he has read and understood the risk warnings.

Annex B

Amendments to the Glossary

In this Annex, underlining indicates new text.

derivative	a *contract for differences*, a *future* or an *option*. (see also *securitised derivative.*)
retail securitised derivative	a *securitised derivative* which is not a specialist securitised derivative; in this definition, a "specialist securitised derivative" is a *securitised derivative* which, in accordance with paragraphs 24.1(m) and 24.6 of the *listing rules*, is required to be admitted to listing with listing particulars which contain a clear statement on the front page that the issue is intended for purchase by only investors who are particularly knowledgeable in investment matters.
securitised derivative	an *option* or *contract for differences* which, in either case, is *listed* under chapter 24 of the *listing rules* (including such an *option* or *contract for differences* which is also a *debenture*). (see also *COB* 5.4.3A G for the treatment of a *securitised derivative.*)