**UK Structured Products Association – Response to European Commission Consultation on CSDR – Additional Information**

Question 34.1

Please explain your answers to question 34, providing where possible quantitative evidence and concrete examples.

The UKSPA supports the industry lobbying to date by certain other industry associations such as ICMA, AFME, ISDA and FIA.

In addition to the arguments presented in those lobbying efforts, there are a number issues specific to, or more acute in, the structured products industry

* + - 1. **Deliverable elements**: Unlike the majority of vanilla bonds and other securities, a number of structured products contain a physically-deliverable element whereby a security, such as a bond in a repacked note is deliverable to the note holder. Like physically-settled derivatives, the deliverable element of the transaction will be subject to the CSDR settlement discipline obligations (where the underlying deliverable is in scope). Unlike physically-settled derivatives, the instrument itself, as a security rather than a derivative, will also be subject to the CSDR settlement discipline obligations. As a result, there could be two buy-in procedures mandated, one for the instrument itself and, if the transfer of the instrument was intended on or around the date of delivery of the underlying, another for the underlying deliverable element.

Well-documented transactions may have an option to receive cash compensation rather than the deliverable security where delivery is impracticable. It would seem more flexible and in line with the parties’ commercial rationale to deal with the underlying deliverable in the transaction documentation rather than through regulation. This may include disruption events, grace periods agreed in line with the commercial objectives of the parties and how they interact with termination events and other rights and obligations, such as liability for costs. Applying mandatory buy-in requirements on top of these existing contractual arrangements would add an additional layer of complexity to the documentation. For a typical investor in structured products, the cost and complexity of establishing and documenting all of the arrangements to enforce a mandatory buy-in are disproportionate when compared to the protections they could obtain through contractual rights to cash compensation where it is built into the terms of the structured product.

For existing transactions where parties have an agreed process to deal with settlement fails, this would likely interact with and disrupt the existing contractual default provisions (including grace periods) in ways that the parties did not contemplate when they entered into the agreement. For example, it may be unclear whether and how the buy-in requirements interact with existing provisions that deal with buy-in costs and when cash compensation can be granted and how it should be calculated.

However, we are aware of uncertainty around whether documentation of existing transactions would need to be amended to incorporate the buy-in procedure at all. In the absence of a carve out for existing transactions, Article 25 RTS on Settlement Discipline does not expressly require the documentation of existing transactions to be amended. Given the potential impact on existing commercial agreements, in the absence of the mandatory buy-in procedure being removed altogether, it would minimise the disruption to the industry by making it clear that existing transactions would not be subject to the settlement discipline rules.

* + - 1. **Liquidity**: Unlike securities which are traded in greater volumes, such as the vanilla bond and equities markets, the structured products market tends to be issued in much smaller volumes, often to service a particular client’s needs. This makes it much more difficult to effect a successful buy-in procedure. Often there isn’t any secondary market liquidity (in terms of both volume and the number of parties willing to trade) or, if there is, liquidity is typically only with the arranger(s) on a transaction. In addition, those arrangers may have conflicts of interest which would preclude them from acting as an independent buy-in agent (if they were willing to, which seems unlikely based on current firms offering buy-in agent services) and it may be that such arrangers are not able to trade with the available buy-in agents.

Furthermore, the tenor for structured products varies and for structured products sold to retail investors, tenors tend to be shorter (for example typical maturities may range from 1-3 years). When considering the deliverable issues, this may contribute to a higher number of buy-in procedures occurring in the market at any one time and exacerbate the lack of liquidity, impacting the likelihood of a buy-in procedure being completed.

* + - 1. **The distribution chain:** With structured products there is often a distribution chain which may include all or some of the following:
         1. issuers to dealers;
         2. dealers to distributors;
         3. distributors to investors;
         4. investors to other investors; and
         5. between investors and market makers.

There are different challenges at each level of the distribution chain. At levels 1 and 2, for a primary issuance in particular, settlement discipline would likely be of limited use given the lack of a secondary market to buy-in securities. The appointment of a third party buy-in agent would likely not be needed and it would also not assist in delivering the security; for structured products, we have explained that there is little or no secondary market and if the issuer failed to issue the securities it is likely that there would be no securities to buy-in.

Distributors and market makers would need to amend their contractual documentation with investors. Such documents may already deal with settlement fails, payment of costs and the ability to opt for cash compensation after a grace period that has been set at a period that is commercially acceptable. The mandatory buy-in regime would add an additional layer of complexity to the documentation and interfere with the commercial agreement of the parties. The cost and complexity of establishing and documenting all the arrangements to enforce a mandatory buy-in are disproportionate when compared to the protections they could obtain through contractual rights that govern the relationship between the distributor and the investor.

Where investors trade with other investors, they may do so with limited contractual arrangements in place. Such investors may be retail clients. To require retail clients to enter into mandatory buy-in requirements would be disproportionate.

Retail investors will struggle to understand how the mandatory buy-in regime works. The procedure is complex and involves multiple steps and stages which vary from liquid securities to other instruments. Terms for retail, as well as elective professional clients are expected to be as short as possible, clear and understandable. The industry has made good progress in providing clear and concise terms to such clients. The mandatory buy-in process will need to contain sufficient detail to ensure it is legally enforceable and will make the terms much longer and more complex, in conflict with the industry’s efforts to simplify terms for such clients. Further, requiring the end retail client to initiate and effectively manage a buy-in process is not appropriate. Those types of clients do not generally understand the market infrastructure and will not be signed up to the buy-in agents that would need to act for them.

Disclosures will also likely need to be made in prospectuses, which is challenging especially from a retail structured products perspective when attempting to simplify terms in order to make them understandable and useful to investors.

If left unchanged, the likely outcome of the CSDR settlement discipline rules to the structured products industry will likely be as documented in other industry responses but heightened given its complexities. Costs are likely to increase (which ultimately will be passed on to end user clients). These may include the not insignificant costs of redocumenting all impacted clients, administration costs of operating the buy-in process (in addition to the distribution of cash penalties) such as maintaining a middle office team to perform this activity and buy-in agency service fees. Liquidity and availability of these products to investors may also diminish, in particular if the firms are unable to pass on the increased costs as a result of a buy-in procedure. It will also add delays and uncertainty to investors’ ability to receive the structured products and the underlying deliverable securities, removing investors’ flexibility to choose between effecting a buy-in, waiting or receiving cash instead.