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Client Alert

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Difficulty in Understanding? ESMA Consultation Paper on Complex Debt Instruments and Structured Deposits

On 24 March 2015, the European Securities and Markets Authority (ESMA) published a Consultation Paper setting out draft guidelines on complex debt instruments and structured deposits.[1]

Background

The Consultation Paper is focussed on a relatively narrow (but important) aspect of the MiFID II[2] legislation, namely the "execution-only exemption". This is already part of the existing MiFID regime and relates to the level of diligence that firms are required to carry out on their clients before providing financial services to such clients. For investment advisory and portfolio management services, a full "suitability" assessment is required under which the firm must obtain sufficient information regarding the client's knowledge and experience, financial situation and investment objectives. For other financial services, including execution-only services, a less stringent "appropriateness" assessment is permitted, which is limited to considering the client's relevant knowledge and experience to enable the firm to assess whether the service or product is appropriate for the client. However, where an execution-only service relates to non-complex financial instruments specified in Article 19(6) of MiFID and certain other conditions apply, the investment firm can provide the service to the client without having to carry out the appropriateness assessment. The Article 19(6) list of instruments includes bonds and similar debt instruments admitted to trading on a regulated market or equivalent third country market but specifically excludes any such bond or other instrument that embeds a derivative.

The execution-only exemption was carefully considered as part of the MiFID II consultation process. The conclusion of the EU Commission was that the exemption should stay but that it should be narrowed by excluding further instruments. Article 19(6) of MiFID will be replaced by Article 25(4) of MiFID II. In addition to the exclusion of debt and other instruments embedding derivatives, it also now excludes (i) bonds or other securitised debt incorporating a structure which makes it difficult for the client to understand the risk involved and (ii) structured deposits which incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before its term. ESMA is required under MiFID II to develop technical standards by 3 January 2016 as to how these additional provisions should be assessed. The ESMA Consultation Paper is the first step in this process.

[1] The Consultation Paper is available at: http://www.esma.europa.eu/system/files/2015-610_cp_mifid_guidelines_complex_products.pdf.
[2] MiFID II refers to the overhaul of the Markets in Financial Instruments Directive (MiFID) comprising the Markets in Financial Instruments Regulation (MiFIR) and a recast MiFID.

What is in the Consultation Paper?

Although MiFID II does not require ESMA to give guidance on the type of instruments that will be regarded as embedding derivatives (which as noted above are already automatically "complex" under MiFID), ESMA believes it is necessary for it to set out guidelines on this issue as well as the "difficult to understand" issue, for the proper understanding of the MiFID II criteria and the proper classification of an instrument as complex or non-complex.

In relation to an embedded derivative, ESMA approves previous definitions that it is a "component of a host contract or instrument—such as a debt instrument—that causes some or all of the cash flows that otherwise would result from the contract or instrument to be modified according to a defined variable, such as the price of a security or the level of a market index or an interest rate or foreign exchange rate". ESMA provides non-exhaustive examples of instruments it believes come within this definition including:

- convertible and exchangeable bonds;
- indexed bonds and turbo certificates;
- contingent convertible bonds (cocos);
- inflation indexed bonds;
- callable or puttable bonds;
- credit-linked notes; and
- warrants.

In relation to debt instruments incorporating a structure making it difficult to understand the risk, ESMA believes this should be interpreted as meaning a structure (and the related risks) that an average retail client would be unlikely to readily understand. ESMA provides non-exhaustive examples of instruments it believes come within this definition including:

- asset-backed securities (ABS) and asset-backed commercial paper (ABCP);
- subordinated debt instruments;
- certificates;
- debt instruments that give the issuer rights to significantly modify the cash-flows;
- perpetual bonds;
- debt instruments with unfamiliar or unusual underlying securities;
- debt instruments structured in a way that may not provide for a full repayment of principal;
- debt instruments that are "packaged products" under the PRIIPs Regulation;
- debt instruments issued by an SPV, in circumstances in which the denomination of the debt instrument or the legal name of the SPV may mislead the investor as to the identity of the issuer or guarantor;

- debt instruments with complex guarantees; and
- debt instruments with leverage features.

ESMA also gives examples of instruments that it would normally not regard as difficult to understand for this purpose (so long as they don't include any of the features listed previously) including (i) step-up notes (which provide for an increasing rate of interest over time), (ii) floating rate notes and (iii) covered bonds.

In relation to structured deposits incorporating a structure making it difficult to understand (a) the risk of return or (b) the cost of exiting before term, ESMA states that the key consideration for (a) is whether the average retail client could reasonably be expected to understand the circumstances in which a return will be paid on the structure and the way in which it will be calculated. It again gives a non-exhaustive list of structures it believes will make it difficult to understand the risk of return including:

- more than one variable that affects the return received;
- a complex relationship that exists between the relevant variable and the return; or
- a variable involved in the calculation of the return that is unusual or unfamiliar to the average retail investor.

For (b), ESMA gives further non-exhaustive examples, including (i) an exit penalty that is not a fixed sum or a fixed rate and (ii) an exit penalty that is not a fixed percentage of the original sum invested.

Effect of Consultation Paper

The execution-only market is still important in financial markets and there are concerns that a significant narrowing of the exemption could have a big impact on the market and impact investor choice and market liquidity. Therefore it is likely that the consultation will be carefully reviewed by market participants. There are probably no huge surprises in the types of instruments that ESMA considers will be included in the "difficult to understand" categories but there may be concerns that ESMA's overall guidance is still very general. Although it gives specific examples of instruments that will be regarded as difficult to understand, it expressly states that these are non-exhaustive and there is likely to be careful thought and analysis given as to other types of instruments that may fall within the exemptions. Although ESMA does give some examples of instruments that will not usually be regarded as "difficult to understand" for this purpose, notably covered bonds, the list is short and it would not be surprising if in the consultation there is a push for ESMA to expressly specify other instruments that it regards as non-complex for this purpose. There will also inevitably be some push-back on some of the instruments ESMA regards as being difficult to understand—for example, it is somewhat baffling as to how the denomination of a debt instrument issued by an SPV could possibly mislead an investor as to the identity of the issuer or guarantor. One wonders whether ESMA is using the term "denomination" to mean the "name" or "designation" of the instrument, rather than the face or nominal value of the debt instrument.

Although the Consultation Paper is focussed on a relatively narrow aspect of MiFID II, it is also likely to have wider significance. The sale and distribution of complex products, particularly to retail investors, is coming increasingly under the microscope of regulators in the EU and elsewhere with various consultation papers on the issue having been published in recent years at the national and international level. Although ESMA's definition of a complex product for the purpose of the MiFID II execution exemption is not necessarily one that will be carried over across the board for other regulation impacting on complex products, its thinking is likely to be very relevant in this area.

The consultation is open for comments until 15 June 2015.

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