European Securities and Markets Authority

Consultation Paper

Draft guidelines on complex debt instruments and structured deposits

24 March 2015 | ESMA /2015/610

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by 15 June 2015**.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading Legal Notice.

Who should read this paper

This paper is primarily of interest to competent authorities and firms that are subject to MiFID, in particular, investment firms and credit institutions performing investment services and activities. This paper is also important for trade associations, investors, and consumer groups, because the guidelines seek to implement enhanced provisions to ensure investor protection with potential impacts for anyone engaged in dealing with or processing of financial instruments.

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Executive Summary

Reasons for publication

Article 25(10) of Directive 2014/65/EU (MiFID II) requires ESMA to develop, by 3 January 2016, guidelines for the assessment of (i) bonds, other forms of securitised debt and money market instruments incorporating a structure which makes it difficult for the client to understand the risk involved and (ii) structured deposits incorporating a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term.

ESMA is consulting on draft guidelines in order to explain its rationale and gather input from stakeholders on the issues covered by the guidelines.

This Consultation Paper (CP) also sets out draft guidelines on related issues that are important for the correct classification of debt instruments (bonds, securitised debt and money market instruments) as either “complex” or “non-complex”, specifically, the concept of embedded derivative for debt instruments.

Contents

Section 1.1 of Chapter 1 explains the background to the proposals. Sections 1.2 and 1.3 respectively set out our proposals, with regard to debt instruments, for understanding the concept of embedded derivative and the concept of a structure which makes it difficult for the client the understand the risk involved. Sections 1.4 and 1.5 respectively set out proposals with regard to structured deposits, for the concept of a structure which makes it difficult for the client to understand the risk of return, and the concept of a structure which makes it difficult for the client to understand the cost of exiting the product before term.

Annexes I and II respectively summarise the questions raised and the relevant legislative provisions. Annex III contains an initial cost-benefit analysis and Annex IV contains the draft guidelines.

Next steps

The consultation will be open until 15 June 2015. Thereafter, ESMA will consider the responses and expects to publish final guidelines in Q4 2015.

1. Principles for guidelines on complex debt instruments and structured deposits

1.1. Background

1. Article 25(4) of MiFID II allows investment firms to provide order-handling services (reception and transmission of orders, as well as execution of orders on behalf of clients) without performing the appropriateness test described in Article 25(3). In addition to certain other conditions, Article 25(4) requires that such services relate to specific types of products – usually termed “non-complex” – including certain types of debt instruments (bonds, other forms of securitised debt and money market instruments) as well as certain types of structured deposits.

2. MiFID II also identifies conditions under which these products cannot be classified as “non-complex”. In doing so, MiFID II narrows the list of non-complex instruments currently regulated by Directive 2004/39/EC (MiFID). In particular, while confirming that debt instruments “that embed a derivative” are complex, MiFID II introduces the following changes to MiFID[1]:

   i. Only bonds and similar debt instruments which are admitted to trading on a regulated market or on an equivalent third country market or on a MTF can potentially be deemed non-complex by the MiFID II provisions.[2]

   ii. The concept of “structure which makes it difficult for the client to understand the risk” is introduced for MiFID debt instruments (including money market instruments).

   iii. Structured deposits are now in the scope of MiFID II (for this particular provision and a number of others) and are defined at Article 4(1)(43).[3]

   iv. The concepts of “structure which makes it difficult for the client to understand the risk of return” and “structure which makes it difficult for the client to understand the cost of exiting” are introduced for structured deposits.

3. MiFID II does not classify structured deposits as ‘financial instruments’; rather, it makes them a distinct type of investment product. Recital 39 makes clear that the definition of structured deposit in Article 4(1)(43) is intended to exclude “deposits linked solely to interest rates, such as Euribor or Libor, regardless of whether or not the interest rates are predetermined, or whether they are fixed or variable”. Similarly, Article 25(4)(a) introduces bespoke standards for structured deposits: they will be complex if they “incorporate a structure which

[1] Changes are also important with respect to shares, UCITS and non-UCITS. See Article 19(6) of MiFID and Article 25(4) of MiFID II in the Annex.
[2] Such listed or traded securities must of course fulfill the other criteria.
[3] This definition is reproduced in Annex II.

makes it difficult for the client to understand the risk of return or the cost of exiting the product before term". Therefore, ESMA wishes to highlight that the guidelines relating to Article 25(4)(a) with regard to structured deposits will not have any automatic read-across to financial instruments, and vice-versa.

4. In addition to enlarging the scope of Article 25(4) to include structured deposits, MiFID II narrows the range of financial instruments that may be sold without the investment firm being required to perform an appropriateness test. This test, as provided by Article 19(5) of MiFID and Article 25(3) of MiFID II, is intended to ensure that clients possess the knowledge and experience necessary to understand the investment decisions they make and the associated risks or, failing that, ensure that they are warned that they may not in fact possess such knowledge and experience before proceeding with the envisaged transaction.

5. Soon after the implementation of MiFID, CESR examined how MiFID provisions relating to complex and non-complex financial instruments should be interpreted, and published a Consultation Paper (CP)[4] to elicit feedback from stakeholders. In addition to addressing general interpretation issues relating to both MiFID and its implementing directive criteria (Article 19(6)[5] of MiFID, and Article 38 of Directive 2006/73/EC), the final 2009 CESR Q&A (developed subsequent to the CP) on "MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements"[6] also addressed several specific issues relating to "debt instruments" broadly, including the concepts of bonds, securitised debt[7] and money market instruments[8], as well as the concept of embedded derivative. This CESR Q&A also indicated how CESR understood that the relevant provisions should apply to particular financial instruments such as covered bonds, subordinated bonds, convertible bonds, asset-backed securities and credit-linked notes. To a large extent, therefore, the draft ESMA guidelines presented in this paper can build on this previous CESR work.

6. Article 25(10) of MiFID II requires ESMA to develop, by 3 January 2016, guidelines for the assessment of:

[4] MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements; 14 May 2009 Ref.: CESR/09-295.

[5] Since analogous wording is used for bonds and other forms of securitised debt in Article 25(4) of MiFID II, ESMA would point out that CESR interpreted the phrase "the service relates to shares admitted to trading on a regulated market" in Article 19(6) as meaning that shares that not admitted to trading on such a market are to be assessed against the criteria in Article 38 of the Level 2 Directive; see §11 and §15 of the CESR Q&A. ESMA considers that bonds and other forms of securitised debt that are not "admitted to trading on a regulated market or on an equivalent third country market or on a MTF" as provided under Article 25(4) should accordingly be assessed against the criteria of the future Level 2 implementing measures, but that the nature of these measures – in particular the liquidity and valuation characteristics required – will in practice mean that such securities will seldom, if ever, be able to be considered non-complex.

[6] http://www.esma.europa.eu/system/files/09_295.pdf, followed by http://www.esma.europa.eu/system/files/09_559.pdf

[7] The CESR Q&A (§33) notes that "securitised debt" means debt that is incorporated into a security, so that "other forms of securitised debt means debt securities other than bonds or money market instruments".

[8] Like MiFID, MiFID II provides "treasury bills, certificates of deposit and commercial papers" as examples of money market instruments (Articles 4(1)(19) and 4(1)17, respectively).

i. bonds, other forms of securitised debt and money market instruments incorporating a structure which makes it difficult for the client to understand the risk involved (instruments referred to in Article 25(4)(a)(ii) and (iii));

ii. structured deposits incorporating a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term (instruments referred to in Article 25(4)(a)(v)).

7. The draft guidelines set out in this CP address these points, as well the concept of embedded derivative that ESMA considers important for the proper understanding of the MiFID II criteria and the proper classification as either “complex” or “non-complex” of debt instruments.

8. ESMA considers it necessary to address both “embedded derivatives” and complex “structures” because these are alternative criteria that need to be differentiated and divergent practices persist despite the previous CESR Q&A.[9] ESMA considers that these draft guidelines are the appropriate tool for addressing all the relevant issues, ensure greater legal certainty as well as provide a consolidated, more user-friendly approach to the classification of debt instruments for MiFID II purposes.

9. Whether or not a debt instrument or structured deposit is considered complex, the relevant investment firm must ensure that all information addressed to its clients or potential clients is fair, clear and not misleading in accordance with Article 24(3) of MiFID II, and provide them with appropriate information about the debt instrument or structured deposit in a comprehensible form, in such a manner that they are reasonably able to understand the risks in accordance with Article 24(4).

10. In addition, investment firms offering either debt instruments or structured deposits, as well as credit institutions selling or advising on structured deposits[10], must comply with the product governance requirements in Article 16(3) to “specify an identified target market of end clients within the relevant category of clients for each financial instrument” and to “ensure that all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market”, regardless of whether the debt instrument or structured deposit is or is not considered complex.

11. ESMA notes that the proposed criteria and the resulting classification as either “complex” or “non-complex” securities or structured deposits contained in these guidelines will only be relevant with regard to Article 25(4) of MiFID II.

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[9] See the response of the Securities and Markets Stakeholder Group to the ESMA Consultation Paper on technical advice to the European Commission, August 2014, paragraph 42.
[10] See Article 1(4) of MiFID II for structured deposits.

1.2. Debt instruments embedding a derivative

12. Under MiFID, bonds, other forms of securitised debt and money market instruments that embed a derivative are automatically considered to be complex and therefore transactions in these debt instruments are subject to the appropriateness test described in Article 19(5) of MiFID. These financial instruments remain automatically complex under Article 25(4) MiFID II.

13. According to existing definitions of this concept[11], an embedded derivative 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 considers that a similar definition would be appropriate for the purposes of Article 24 (4) of MiFID II.

14. ESMA also notes that Article 38 of directive 2006/73/EC (MiFID implementing directive) deems as complex all derivatives as defined by MiFID (points (4) to (10) of Section C of Annex I to MiFID) as well as all securities that fall within point (c) of Article 4(1)(18) of MiFID that defines transferable securities.[12] The latter type of securities – those that give a right to buy or sell another security or give rise to a cash settlement determined by reference to any index or measure such as a security price, currency rate or interest rate – may also generally be considered as embedding a derivative. Such securities are to be deemed complex both under MiFID and under MiFID II.

15. In light of this framework, the draft guidelines in Annex IV intend to clarify the types of debt instruments that should be deemed to embed a derivative and therefore be complex for the purpose of the appropriateness requirements under MiFID II.

16. The list below, which is non-exhaustive, sets out types of debt instruments that are generally deemed to embed a derivative:

    i. Convertible and exchangeable bonds

       Bonds that holders or issuers may convert or exchange into shares of the bond issuer (or shares of another company, such as an affiliate) are common in the capital markets. The option to exercise such a right to convert or exchange is to be understood as indicating that they embed a derivative. Convertible and exchangeable bonds (regardless of the type of security to which the conversion or exchange gives rise) are therefore deemed to be complex securities for the purpose of Article 25(4) of MiFID II.

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[11] See International Accounting Standards (IAS 39.10) or Article 10 of Directive 2007/16 Implementing Directive 85/611/EC (now Directive 2009/65/EC).

[12] ESMA notes that these draft guidelines are published for consultation on the assumption that the mentioned provisions of Article 38 of the Directive 2006/73 are maintained under MiFID II.

These bonds, as well as several of the other securities discussed below, may also be considered complex by virtue of the provision in Article 38 of the current MiFID implementing directive (and that should be maintained under MiFID II) that deems complex any security that falls under point (c) of the definition of transferable securities (currently Article 4(18) of MiFID; Article 4(1)(44) of MiFID II).

ii. Indexed bonds and “turbo” certificates[13]

Indexed bonds and “turbo” certificates are debt instruments the pay-off of which – i.e. ther the coupon or the repayment of principal or both - is based on a formula that is typically related to the level of an equity index, individual equity price or other price level. They must be considered to embed a derivative and should therefore be deemed to be complex securities.

iii. Contingent convertible bonds

Contingent convertible bonds (cocos) are debt securities where the principal amount may be cancelled, reduced or converted into equity in certain circumstances relating, for example, to the level of own funds of the issuing institution, and/or the coupon payable modified in a discretionary way by the issuer. Their features indicate an embedded derivative, and therefore cocos should be deemed complex.

In addition, cocos may be deemed to incorporate a structure making it difficult to understand the risk since these instruments are governed by complex legal documentation which could be challenging for investors to understand. This alternative approach would be relevant, however, only where the relevant cocos may be considered as not embedding a derivative.

iv. Inflation-indexed bonds

A bond where repayment of the principal or the coupon amount varies with an inflation rate should be considered as embedding a derivative. Therefore, it should be deemed complex.

v. Callable or puttable bonds

A callable bond allows the issuer to impose the repayment of principal before the normal maturity of the bond. A puttable bond allows the investor to sell the bond back to the issuer in defined conditions. Both of these bond types embed a derivative and should accordingly be deemed complex securities.

[13] The term “certificate” is used here in its common meaning i.e. a type of indexed debt instrument or structured note that is offered to many retail clients. This differs from the specific meaning of the term in the context of MiFIR market transparency requirements. See the Annex for the MiFIR definition of “certificate”.

vi. Credit-linked notes

A credit-linked note is essentially a security with an embedded credit default swap, allowing the issuer to transfer a specific credit risk to investors. It should therefore be deemed to be a complex security.

vii. Warrants[14]

Most warrants are similar to options, but they are securities in many legal systems (for example, they are admitted to the operations of central securities depositories and have ISIN codes) and not derivatives within the meaning of points (4) to (10) of Annex I of MiFID. Such securities must be deemed to embed a derivative and should therefore be deemed complex.

Where under the legal system of a particular jurisdiction, warrants are considered to be derivatives (and classified in points (4) to (10) of Annex I of MiFID), they will be deemed complex by virtue of Article 38 of the MiFID implementing Directive.[15]

Question 1: Do you agree with the examples of debt instruments that are generally deemed to embed a derivative? If not, which examples do you not agree with, and why not?

Question 2: Do you agree with the definition of embedded derivative proposed in the Guidelines in Annex IV? If not, why not?

[14] The term "warrant" is used here in its usual meaning i.e. a type of leveraged security that typically gives rise to a cash payoff upon exercise and is popular with many retail clients. This type of security is different from an equity warrant the exercise of which gives rise to a delivery of equity securities to the investor.
[15] This provision is reproduced in the Annex.

1.3. Debt instruments incorporating a structure making it difficult for the client to understand the risk

17. In its 2009 Q&A to address the complexity of certain securities that do not embed a derivative, such as asset-backed securities (ABS), CESR suggested the concept of a "structure making it difficult to understand the risk" (for all types of debt instruments including money market instruments). This concept has been carried through to the MiFID II, in line with the objective of MiFID to strengthen the protection of investors. Similarly to securities embedding a derivative, debt instruments that incorporate such a structure are considered to be complex and therefore transactions in these securities are subject to the requirements concerning the appropriateness test described in Article 25(3) of MiFID II.

18. On the other hand, it should be emphasised that, in accordance with Article 25(4) of MiFID II, these guidelines address the aspect of the complexity of debt securities and not their risk. Some high-risk financial instruments can be relatively easy to understand and therefore are not deemed complex. For example, in line with MiFID II, ordinary, non-subordinated debt instruments, may be riskier but they are more likely to be understandable by the average retail client.

19. The intention of the draft guidelines in Annex IV is to clarify the types of debt instruments that should be deemed to incorporate a structure making it difficult for the client to understand the risk, and therefore be deemed complex for the purpose of the appropriateness requirements under MiFID II.

20. In the draft guidelines ESMA considers that, for the purpose of points (ii) and (iii) of Article 25(4)(a) of MiFID II, a structure making it difficult for the client to understand the risk should be interpreted as meaning a structure and the related risks that an average retail client would be unlikely to readily understand. On the basis of this general criterion, ESMA provides a non-exhaustive list of common relevant securities with the identification of the rationale justifying their classification among the financial instruments generally deemed to incorporate such a structure.

21. The following types of debt instruments, which are non-exhaustive, are generally deemed to be complex by virtue of the above:

    i. Asset-backed securities and asset-backed commercial papers [16]

    The holder of an asset-backed security or asset-backed commercial paper relies directly and solely on the quality of the underlying assets - typically real property loans or consumer loans - for the repayment of the principal amount of the instrument. Such

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[16] These instruments are generally known as structured finance products. See the MiFIR definition of "structured finance products" in Annex II

instruments, regardless of whether they are tranched or not, and regardless of their credit rating (if any), should be regarded as incorporating a structure that makes it difficult for the investor to understand the risk involved. They will accordingly always be complex for the purposes of Article 25(4) of MiFID II.

Examples of ABS include Residential Mortgage Backed Securities (RMBS), Commercial Mortgage Backed Securities (CMBS) and Collateralised Debt Obligations (CDOs).

ii. Subordinated debt instruments

The holder of a subordinated debt instrument (or subordinated commercial paper) is in a less favourable position than the holder of an ordinary debt instrument, since the reimbursement of the latter is not subordinated to the prior reimbursement of the debt held by others. This less favourable position is difficult to understand for the average retail investor. The prospectus and/or legal documentation of such securities is also challenging to understand. Such securities should therefore be regarded as complex.

iii. Certificates

Certificates, as defined in MiFIR (see the Annex), are a form of subordinated debt and are therefore complex securities.

iv. Debt instruments with issuer discretion

Where under the terms and conditions an issuer enjoys the right to modify significantly the cash flows related to the security, for example the payment of interest, the security should be considered complex, regardless of whether or not it may be deemed to embed a derivative.

v. Perpetual bonds

Perpetual bonds have no predetermined maturity date, are not redeemable by the investor and only pay interest. They combine features typical of debt instruments (coupons) and equity instruments (no maturity). Therefore, investors may be led to underestimate the fact that, unlike typical bonds, they will never receive back the initial capital invested. In addition, credit risk is extremely difficult to understand over such an infinite time period, and the structure of the bond tend to increase the volatility of its market price. The risks associated with perpetual bonds are therefore difficult to understand, and such securities should be regarded as complex.

In addition, perpetual bonds – as well as the majority of long-dated bonds (i.e. having a term greater than 10 or 15 years) – very often contain an issuer call option to repay the principal before maturity, in which case they are to be regarded as embedding a derivative.

vi. Debt instruments with an unfamiliar or unusual underlying

Debt instruments the return of which is referenced to an underlying that is likely to be unfamiliar to the average retail investor should be considered complex because such an investor will generally be unable to assess the risks resulting from such a structure.

Examples of an unfamiliar or unusual underlying would include non-public benchmarks, synthetic indices, niche markets, highly technical measures such as price volatility and combinations of variables (i.e. more than one variable affecting the return).

In most cases such securities will embed a derivative, but there may be exceptions. For example, catastrophe bonds (cat bonds) are a form of securitisation of insurance risk. Where the catastrophe – such as a natural disaster – occurs during the life of the bond, the principal is used in whole or in part to indemnify the losses covered by an insurance contract; investors accordingly lose all or part of their investment. Such structures and the related risks are very difficult to understand for the average retail investor, so catastrophe bonds should be deemed complex.

Similarly, a debt instrument denominated in a currency which is not the one of the jurisdiction (or a currency that is pegged to the currency of the jurisdiction) where the investment services are provided should be considered a structure making it difficult to understand the risk involved because the investor has difficulties to understand the associated effect of credit risk and currency risk.

vii. Debt instruments structured in a way that may not provide for a full repayment of the principal amount

The average retail investor will expect a bond or other debt instrument to repay in full the principal amount at maturity. Where, as a result of the way in which the debt instruments are structured, this is not the case, the bond should be deemed complex, since the average retail investor is unlikely to fully understand this type of structure.

Examples will include a security that provides for repayment of only part of the principal or that provides for full repayment only if certain conditions are satisfied. For instance some forms of hybrid securities are structured in a way that once the capital of the issuer falls below a stated threshold, a loss-absorbency mechanism means that the value of the bond can be partially or wholly written down (either temporarily or permanently).

viii. Debt instruments that would classify as “packaged products” under the PRIIPs Regulation

ESMA considers that in addition to any debt instrument mentioned in paragraph 16 above or in this paragraph 21, debt instruments where the amount repayable is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the investor should normally be considered complex for the purpose of Article 25(4) of MiFID. Therefore, unless otherwise specified[17], debt instruments that would be regarded as a "packaged product" by virtue of Article 4(1) of the PRIIPS Regulation should be deemed complex for the purpose of Article 25(4) of MiFID II[18].

ix. Debt instruments issued by a special purpose vehicle (SPV)

A special purpose vehicle can be defined as an entity created principally or exclusively for the purpose of issuing securities. When a SPV issues debt instruments, the redemption and/or debt service of such security is often highly dependent on the assets and cash flow of that SPV. Likewise, the existence and the functioning of a guarantee by a third party has an impact on the risk profile of the instrument and the exposure of the investor.

ESMA is of the view that the way in which a SPV issues and structures a debt instrument may in certain circumstances impair retail investors' ability to fully understand the risks involved.

For this reason, ESMA considers that debt instruments issued by a SPV should be deemed as complex when the denomination of the debt instrument or the legal name of the SPV may increase the difficulty for an average retail investor to assess adequately the risks associated with an investment in such debt instruments notably by leading such a retail investor to believe that such debt instrument is issued or guaranteed by an entity different from the one it is actually issued or guaranteed by.

x. Debt instruments with complex guarantees of repayment of principal

Debt instruments may in some cases incorporate a guarantee by a third party of the repayment of principal. In these cases, where the guarantee mechanism (i.e. level of guarantee, terms and conditions of the guarantee, determination of the guarantor) is structured in a way which does not enable the investor to assess accurately how such a guarantee mechanism affects the risk exposure when investing in the debt instruments, the debt instrument should be considered complex for the purpose of these guidelines. Examples may be guarantee mechanisms where the trigger for the guarantee depends upon one or several conditions in addition to the default of the issuer and guarantee mechanisms where the level of guarantee or the actual trigger of the guarantee are subject to time limitations.

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[17] MiFID II expressly identifies some "packaged products" falling in the scope of the directive as non-complex for the purpose of Article 25(4): this is the case for UCITS (excluding structured UCITS) and structured deposits (excluding those that incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term).

[18] The Joint Committee of the ESAs published a Discussion Paper (DP) on Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs) on 17 November 2014 (JC/DP/2014/02). The DP covers any type of PRIIPs (including those which do not fall within the scope of MiFID II) and deals, inter alia, with the comprehension alert for the purpose of Article 8(3)(b) of the PRIIPs Regulation.

xi. Debt instruments with leverage features

Most leveraged debt instruments will embed a derivative. It may be possible however to introduce leverage into a debt instrument without recourse to a derivative. Also in such a case, the security should be regarded as complex by virtue of the leverage effect, since the average retail investor would find this feature challenging to understand. ESMA considers that this would be the case where the leveraged structure means that the investor could experience losses or gains at significant multiples to their initial investment. For the average retail investor this feature can mean it is difficult to predict losses and gains and therefore assess the financial impact of purchasing these types of securities.

22. The following types of debt instruments, which are non-exhaustive examples, are generally deemed to be non-complex by virtue of the above criteria (provided they are admitted to trading on a regulated market or equivalent third country market or traded on a MTF):

i. Step-up notes

A bond that simply provides for an increasing rate of interest over time according to a predefined schedule is not difficult to understand and should be deemed non-complex.

This classification assumes that such an increase in coupons is the only particularity of the security. Should the step-up notes be callable by the issuer for example, they would be complex.

ii. Floating-rate notes

A note whose coupon varies with Libor or Euribor for example should be considered non-complex.

Again, this classification assumes that a variable interest rate is the only specific feature of the security and that the benchmark is itself easy to understand. Where the interest rate paid on the coupon is referenced to more than one variable or varies in the opposite direction from a standard market benchmark such as Libor or Euribor (reverse FRNs), for example, the note should be deemed complex.

iii. Covered bonds

Traditional covered bonds are corporate bonds with an enhancement in the form of recourse to a ring-fenced pool of assets that remains on the balance sheet of the issuer. This asset pool secures or “covers” the bond if the issuer – usually a financial institution - becomes insolvent. In the event of insolvency, the investor has access to both the pool of assets and the issuer. The pool of assets is replenished by the issuer if some of the assets within the pool become impaired or reduce in credit quality.

The holder of such a covered bond, unlike the holder of an asset-backed security, has a claim not only on the underlying assets but also a direct claim against the issuer of the covered bond. This latter feature is easy to understand since it shared by ordinary bonds, so covered bonds should be deemed non-complex.

23. Any of the debt instruments mentioned in the above paragraph 22 would be complex, however, were they to embed a derivative or fall under point (c) of the definition of transferable securities, for example a convertible or callable floating-rate note or a convertible covered bond.

Question 3: Do you agree with the examples of debt instruments that incorporate a structure making it difficult for the client to understand the risk? If not, which examples and why not?

Question 4: Do you agree with the definition of a structure making it difficult for the client to understand the risk included in the Guidelines in Annex IV? If not, why not?

1.4. Structured deposits incorporating a structure making it difficult for the client to understand the risk of return

24. The draft guidelines in Annex IV intend to clarify the types of structured deposits that should be deemed to incorporate a structure making it difficult for the client to understand the risk of return and therefore should be considered complex for the purposes of the Directive's appropriateness requirements. It explains how ESMA understands the concept and provides a non-exhaustive list of examples.

25. MiFID II introduces, specifically for structured deposits, this criterion of incorporating a structure making it difficult for the client to understand the risk of return. If a structured deposit meets either this criterion or the one discussed in the next section (incorporating a structure making it difficult for the client to understand the cost of exiting before term), it will be considered complex.

26. The specificity of this particular requirement reflects the nature of deposit products. Clients do not face the same range of risks when investing in structured deposits as they do when investing in many financial instruments. Indeed, structured deposits are always fully repayable at maturity and, in case of insolvency of the deposit-taker, they are covered under the relevant deposit guarantee scheme. Therefore, the investment risk taken by the client is the risk of receiving a variable return on the deposit. So, a structured deposit should be considered complex if it is difficult to understand in what circumstances a return will be achieved, or how large or small the return may be.

27. Under this test, the key consideration is whether the average retail client could reasonably be expected to understand the circumstances in which a return will be paid on the structured deposit and the way in which it will be calculated. These factors will, in turn, determine whether a client is able to make a reasonable assessment as to whether or not he/she is likely to receive a return - and how large or small this return might be in different circumstances - before investing in a structured deposit. In practice, a client may need to use this information to infer how attractive a structured deposit is compared to other investments or deposits (potentially including ordinary fixed-term deposits, which are outside of the scope of MiFID).

28. When thinking of a structured deposit, it is common to think of a product where the return is linked to the performance of a particular index, e.g. a bank account where a bonus is paid at maturity that equates to a set percentage of any positive movement in a particular stock index, such as the DAX or the FTSE. But it is quite possible for structured deposits to have a return that is linked to another variable than an index, e.g. the price of a particular commodity or other asset. With this in mind, the present paper refers to the 'variable' or 'variables' affecting the return on a structured deposit, rather than to indices specifically, so as to include any possible underlying or reference value.

29. If, given the nature of a structured deposit, it is reasonable to think that the client will be able to understand in what circumstances a return will be paid, how it will be calculated and

when it will be paid, a structured deposit will be capable of meeting the criteria in Article 25(4)(a)(v) to be considered non-complex. But, if the return on a structured deposit – either the interest or capital appreciation or both - may for any reason be deemed complex to understand, the structured deposit should be considered complex.

30. The following list, which is non-exhaustive, describes structures deemed to make a structured deposit complex by virtue of the above criterion:

i. More than one variable affects the return received

Where two or more variables affect the return on a structured deposit, it should be considered complex. For example, if a basket of instruments or assets (as opposed to a single index) all have to outperform a specified benchmark for a return to be paid, or if the return is determined by the combination of two or more indices, the structured deposit will be complex.

ii. A complex relationship exists between the relevant variable and the return

Where the way in which the return is linked to the relevant variable is complicated for the client to understand, this will make the product complex. If the relationship determining how the change in the price level of an index is reflected in the return is not simple – because it involves different market data points such as one or more thresholds that have to be met or several index measurements at different dates, or because the capital gain or interest payable steps up or down in certain specific circumstances for example – then the structured deposit should be considered complex.

iii. An unfamiliar or unusual variable is involved in the calculation of the return

Where the return is dependent on a variable that is likely to be unfamiliar to the average retail investor, opaque or otherwise difficult for a retail client to comprehend, the structured deposit should be considered complex. For example, if the return on a structured deposit is linked to any of the following, the structured deposit should be deemed complex:

- an unusual or unfamiliar market from the perspective of the average retail client in the relevant Member State;
- a niche market;
- an in-house index or other non-public benchmark;
- a synthetic index;
- a highly technical measure, such as asset price volatility;
- an innovative financial structure; or

- a currency which is not the one of the jurisdiction where the structured deposit is offered.

Question 5: Do you agree with the definition of a structure making it difficult for the client to understand the risk of return of structured deposits and with the relevant examples proposed? If not, why not?

1.5. Structured deposits incorporating a structure making it difficult for the client to understand the cost of exiting before term

31. The draft guidelines in Annex IV intend to clarify the types of structured deposits that should be deemed to incorporate a structure making it difficult for the client to understand the cost of exiting the product before the term and therefore should be considered complex. They explain how ESMA understands the concept and provides a non-exhaustive list of examples.

32. MiFID II introduces, specifically for structured deposits, this criterion of incorporating a structure that makes it difficult for the client to understand the cost of exiting the product before term. If a structured deposit meets either this criterion or the one discussed in the previous section (incorporating a structure making it difficult for the client to understand the risk of return) it will be considered complex.

33. As with the previous section, the specificity of this second requirement also reflects the nature of deposits. A key risk facing clients investing in structured deposits may be the possibility of incurring a financial penalty in the event that they want access to their money before the agreed term.

34. Where the average retail client is easily able to understand the cost of early exit, structured deposits are capable of meeting the criteria in Article 25(4)(a)(v) in order to be considered non-complex. An obvious example of this would be where there is no penalty for early exit, but other structures are capable of meeting the test.

35. The following list of exit penalties, which is non-exhaustive, should be viewed as making a structured deposit complex, by virtue of the above criterion:

    i. An exit penalty that is not a fixed sum. For example, a product having a variable or 'capped' exit penalty (such as 'you will be charged up to 300 euros if you exit early'), or a product referencing a variable factor such as an interest rate, should be considered complex.

    ii. An exit penalty that is not a fixed sum for each month remaining until the agreed term

    For example, a firm might describe a penalty where 'if you want your money back before the year is up you will be charged up to 50euros per month for each month left to go'.

    iii. An exit penalty that is not a percentage of the original sum invested

    For example, where a product has an exit penalty that will be at least equal to the amount of the returns accrued until the early exit date would make it difficult for the client to understand the exact amount, and should therefore be considered complex.

Question 6: Do you agree with the definition of a structure making it difficult for the client to understand the cost of exiting a structured deposit before term and with the relevant examples proposed? If not, why not?

1.6. Potential impact of the guidelines

Question 7: Please provide any specific evidence or data that would further inform the analysis of the likely cost and benefit impacts of the guidelines.

2. Annexes

Annex I - Summary of questions

Question 1: Do you agree with the examples of debt instruments that embed a derivative? If not, which examples do you not agree with, and why not?

Question 2: Do you agree with the definition of embedded derivative proposed in the Guidelines in Annex IV? If not, why not?

Question 3: Do you agree with the examples of debt instruments that incorporate a structure making it difficult for the client to understand the risk? If not, which examples and why not?

Question 4: Do you agree with the definition of a structure making it difficult for the client to understand the risk included in the Guidelines in Annex IV? If not, why not?

Question 5: Do you agree with the definition of a structure making it difficult for the client to understand the risk of return of structured deposits and with the relevant examples proposed? If not, why not?

Question 6: Do you agree with the definition of a structure making it difficult for the client to understand the cost of exiting a structured deposit before term and with the relevant examples proposed? If not, why not?

Question 7: Please provide any specific evidence or data that would further inform the analysis of the likely cost and benefit impacts of the guidelines.

Annex II - Legislative mandate to develop guidelines and relevant legislation

1. Article 16 of Regulation (EU) No 1095/2010 of the European Parliament and of the Council (ESMA Regulation) empowers ESMA to issue guidelines and recommendations addressed to competent authorities or financial market participants, with a view to establishing consistent, efficient and effective supervisory practices within the ESFS, and to ensuring the common, uniform and consistent application of Union law.

2. Furthermore, Article 25(10) of MiFID II requires ESMA to develop by 3 January 2016, and update periodically, guidelines for the assessment of:

   a. financial instruments incorporating a structure which makes it difficult for the client to understand the risk involved in accordance with points (a)(ii) and (a)(iii) of paragraph 4;

   b. structured deposits incorporating a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term, in accordance with point (a)(v) of paragraph 4.

MiFID and MiFID II provisions on the scope of the so-called "execution-only" regime

Article 19(6) of MiFID

Member States shall allow investment firms when providing investment services that only consist of execution and/or the reception and transmission of client orders with or without ancillary services to provide those investment services to their clients without the need to obtain the information or make the determination provided for in paragraph 5 where all the following conditions are met:

- the above services relate to shares admitted to trading on a regulated market or in an equivalent third country market, money market instruments, bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative), UCITS and other non-complex financial instruments. A third country market shall be considered as equivalent to a regulated market if it complies with equivalent requirements to those established under Title III. The Commission shall publish a list of those markets that are to be considered as equivalent. This list shall be updated periodically;

- the service is provided at the initiative of the client or potential client,

- the client or potential client has been clearly informed that in the provision of this service the investment firm is not required to assess the suitability of the instrument or service provided or offered and that therefore he does not benefit from the corresponding protection of the relevant conduct of business rules; this warning may be provided in a standardised format;

- the investment firm complies with its obligations under Article 18.

Article 25(4) of MiFID II

Member States shall allow investment firms when providing investment services that only consist of execution or reception and transmission of client orders with or without ancillary services, excluding the granting of credits or loans as specified in Section B.1 of Annex I that do not comprise of existing credit limits of loans, current accounts and overdraft facilities of clients, to provide those investment services to their clients without the need to obtain the information or make the determination provided for in paragraph 3 where all the following conditions are met:

a. the services relate to any of the following financial instruments:

    i. shares admitted to trading on a regulated market or on an equivalent third-country market or on a MTF, where those are shares in companies, and excluding shares in non-UCITS collective investment undertakings and shares that embed a derivative;

    ii. bonds or other forms of securitised debt admitted to trading on a regulated market or on an equivalent third country market or on a MTF, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;

    iii. money-market instruments, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;

    iv. shares or units in UCITS, excluding structured UCITS as referred to in the second subparagraph of Article 36(1) of Regulation (EU) No 583/2010;

    v. structured deposits, excluding those that incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term;

    vi. other non-complex financial instruments for the purpose of this paragraph.

    For the purpose of this point, if the requirements and the procedure laid down under the third and the fourth subparagraphs of Article 4(1) of Directive 2003/71/EC are fulfilled, a third-country market shall be considered to be equivalent to a regulated market.

b. the service is provided at the initiative of the client or potential client;

c. the client or potential client has been clearly informed that in the provision of that service the investment firm is not required to assess the appropriateness of the financial instrument or service provided or offered and that therefore he does not benefit from the corresponding protection of the relevant conduct of business rules. Such a warning may be provided in a standardised format;

d. the investment firm complies with its obligations under Article 23.

Definition of "structured deposit" in MiFID II

Article 4(1)(43) of MiFID II

'Structured deposit' means a deposit as defined in point (c) of Article 2(1) of Directive 2014/49/EU of the European Parliament and of the Council (1), which is fully repayable at maturity on terms under which interest or a premium will be paid or is at risk, according to a formula involving factors such as:

a. an index or combination of indices, excluding variable rate deposits whose return is directly linked to an interest rate index such as Euribor or Libor;

b. a financial instrument or combination of financial instruments;

c. a commodity or combination of commodities or other physical or non-physical non-fungible assets; or

d. a foreign exchange rate or combination of foreign exchange rates;

Definition of "certificates" in MiFIR

Article 2(1)(27) of MiFIR

'Certificates' means those securities which are negotiable on the capital market and which in case of a repayment of investment by the issuer are ranked above shares but below unsecured bond instruments and other similar instruments;

Definition of "structured finance products" in MiFIR

Article 2(1)(28) of MiFIR

'Structured finance products' means those securities created to securitise and transfer credit risk associated with a pool of financial assets entitling the security holder to receive regular payments that depend on the cash flow from the underlying assets;

Definition of transferable securities

Article 4(1)(18) of MiFID and Article 4(1)(44) of MiFID II

'Transferable securities' means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:

a. shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;

b. bonds or other forms of securitised debt, including depositary receipts in respect of such securities;

c. any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures;

Article 38 of the MiFID implementing directive (2006/73/EC)[19]

Provision of services in non-complex instruments

A financial instrument which is not specified in the first indent of Article 19(6) of Directive 2004/39/EC shall be considered as non-complex if it satisfies the following criteria:

a. it does not fall within Article 4(1)(18)(c) of, or points (4) to (10) of Section C of Annex I to, Directive 2004/39/EC;

b. there are frequent opportunities to dispose of, redeem, or otherwise realise that instrument at prices that are publicly available to market participants and that are either market prices or prices made available, or validated, by valuation systems independent of the issuer;

c. it does not involve any actual or potential liability for the client that exceeds the cost of acquiring the instrument;

d. adequately comprehensive information on its characteristics is publicly available and is likely to be readily understood so as to enable the average retail client to make an informed judgment as to whether to enter into a transaction in that instrument.

[19] In ESMA's technical advice to the European Commission on the implementing measures of MiFID II, it recommends maintaining the four current criteria of Article 38 and adding two additional criteria (ESMA/2014/1569 of 19 December 2014, p. 160).

Annex III - Cost-benefit analysis

36. This CP sets out draft guidelines on issues that are important for the correct classification of MiFID debt instruments (bonds, securitised debt and money market instruments) and structured deposits as either “complex” or “non- complex”. The criteria proposed in this CP and the resulting classification as “complex” or non-complex securities or structured deposits will only be relevant with regard to Article 25(4) of MiFID II.

37. This section presents a qualitative assessment of the potential costs and benefits of the proposed guidelines

38. To a large extent these draft ESMA guidelines build on the previous work from CESR which provided a detailed steer to firms as to what should and should not be regarded as a complex instrument and therefore what could and could not be provided on an “execution-only” basis. MiFID II has made changes summarized in Chapter 1, paragraph 2 as:

    i. Only “listed/traded” bonds and similar debt instruments can potentially be deemed non-complex by the Level 1 provision.

    ii. The concept of “structure which makes it difficult for the client to understand the risk” for MiFID debt instruments (including money market instruments) is new.

    iii. Structured deposits are now in the scope of MiFID II (for this particular provision and a number of others) and are defined at Article 4(1)(43).

    iv. For structured deposits, the concepts of “structure which makes it difficult for the client to understand the risk of return” and “structure which makes it difficult for the client to understand the cost of exiting” are also new.

39. However, since a large majority of MiFID instruments will already have been covered by the previous CESR guidance on complex financial instruments, these guidelines will apply to or cover a relatively small universe of additional financial instruments. Therefore, ESMA does not anticipate they will significantly impact on firms and their current practices.

40. On structured deposits, the inclusion of these products under MiFID II is new and will imply the application of MiFID II rules as a result of the legislative inclusion in the scope of the new directive. The general criteria for the classification of complex structured deposits are already identified in MiFID II. These guidelines only propose detailed factors for the application of the MiFID II general criteria and should not have a significant additional impact on firms.

41. It is therefore anticipated that these guidelines will generate limited additional compliance costs for firms with moderate incremental costs incurred where firms must modify their internal arrangements for the distribution of certain investment products and training. For example, they will need to update their training of staff to ensure that in light of these guidelines, only non-complex instruments are provided in accordance with Article 25(4) of MiFID II (so-called “execution-only” basis). Since firms should normally already incur the cost of training

new staff and updating the training (and training material) for existing staff, there would again be moderate incremental impact on a firm's budget to design training for staff on products considered to be complex.

42. The benefits of these guidelines arise principally from offering further protection to investors and minimizing detriment associated with any debt instrument being sold to investors where they are unable to assess the risk involved or in the case of structured deposits cannot assess the risk of return or the cost of exiting the product. Furthermore, the guidelines add clarity on what products are considered complex and therefore cannot be sold on an execution-only basis.

Annex IV - Draft guidelines on complex debt instruments and structured deposits

I. Scope

Who?

1. These guidelines apply to:

    a. firms and

    b. competent authorities.

What?

2. These guidelines are important for the correct classification of MiFID debt instruments (bonds, securitised debt and money market instruments) and structured deposits as either “complex” or “non-complex” for the purpose of Article 24(4) of MiFID II.

When?

3. These guidelines apply from [date]

II. Purpose

4. The purpose of these guidelines is to specify the criteria for the the assessment of (i) bonds, other forms of securitised debt and money market instruments incorporating a structure which makes it difficult for the client to understand the risk involved and (ii) structured deposits incorporating a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term.

5. These guidelines also clarify the concept of “embedded derivatives” in order to provide an overall framework for the application of Article 25(4)(a) in relation to debt instruments.

6. ESMA expects these guidelines to promote greater convergence in the classification of “complex” or “non-complex” financial instruments or structured deposits for the purpose of the provision of investment services in accordance with Article 25(3) and 25 (4) of MiFID II.

III. Definitions

7. Unless otherwise specified, terms used in the Directive 2014/65/EU (MiFID II) have the same meaning in these guidelines. In addition, the following definitions apply:

- MiFID means the Markets in Financial Instruments Directive - Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instrument.

- MiFID II means: Directive 2014/65/EU of The European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast).

- Competent authority (or NCA) means an authority designated under Article 67 of MiFID II.

- Firms mean investment firms (as defined in Article 4(1)(1) of MiFID II) and credit institutions when providing investment services and external Alternative Investment Fund Managers (AIFMs) when they are providing non-core services (within the meaning of Article 6(4)(a) and (b) of the AIFMD).

- Debt instruments means: bonds, other forms of securitised debt and money market instruments.

IV. Compliance and reporting obligations

Status of the guidelines

8. This document contains guidelines issued under Article 16 of the ESMA Regulation. In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants must make every effort to comply with the guidelines.

9. Competent authorities to whom the guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines are directed primarily at financial market participants.

Reporting requirements

10. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, stating their reasons for non-compliance where they do not comply or do not intend to comply, within two months of the date of publication of the translated versions by ESMA to […]@esma.europa.eu. A template for notifications is available from the ESMA website.

11. Financial market participants are not required to report whether they comply with these guidelines.

V. Draft Guidelines

V.I. Debt instruments embedding a derivative

12. For the purpose of points (ii) and (iii) of Article 25(4)(a) of MiFID II, an embedded derivative should be interpreted as meaning a component of a debt instrument that causes some or all of the cash flows that otherwise would result from the instrument to be modified according to one or more defined variables.

V.II. Debt instruments incorporating a structure making it difficult for the client to understand the risk

13. For the purpose of points (ii) and (iii) of Article 25(4)(a) of MiFID II, a structure making it difficult for the client to understand the risk should be interpreted as meaning a structure and the related risks that an average retail client would be unlikely to readily understand. This should be the case where the characteristics of the debt instrument differ substantially from those of ordinary, simple bonds.

14. Debt instruments incorporating a structure making it difficult to understand the risk should include inter alia the following:

   a) <u>Debt instruments, the return of which is dependent on the performance of a defined asset pool</u>. Debt instruments the return or performance of which depends on the receivables either fixed or revolving generated by the assets in the underlying pool.

   b) <u>Debt instruments, the return of which is subordinated to the reimbursement of debt held by others</u>. Debt instruments structured in such a way that in the event of default by the issuer, the senior debt holders have priority to the assets of the issuer over the subordinated holders.

   c) <u>Debt instruments where the issuer enjoys discretion to modify the cash flows of the instrument</u>. Debt instruments structured in such a way that the anticipated revenue stream or repayment of principal is dependent on variables which are dependent on wide issuer’s discretion.

   d) <u>Debt instruments lacking a specified redemption date or maturity</u>. Debt instruments structured in such a way that there is no specified maturity date and typically therefore no re-payment of the principal amount invested (while an on-going coupon payment is normally made at regular intervals).

   e) <u>Debt instruments having an unusual or unfamiliar underlying</u>. Debt instruments structured in such a way that the anticipated revenue stream or repayment of principal is dependent on variables which are unusual or unfamiliar for the average retail investor.

f) Debt instruments structured in a way that may not provide for a full repayment of the principal amount. Debt instruments presenting a structure or a mechanism which, in certain circumstances, trigger a partial repayment (or no repayment) of the principal.

g) Debt instruments that would be regarded as a packaged product by virtue of Article 4(1) of the PRIIPs Regulation (Regulation (EU) 1286/2014) with the exclusion of the financial instruments for which the provision of services in accordance with Article 25(4) of MiFID II is expressly allowed.

h) Debt instruments issued by a special purpose vehicle in circumstances in which the denomination of the debt instrument or the legal name of the SPV may mislead the investors as to the identity of the issuer or guarantor.

i) Debt instruments with complex guarantee mechanisms. Debt instruments guaranteed by a third party and structured in a way that makes it complex for the investor to assess accurately how the guarantee mechanism affects the risk exposure of the investment.

j) Debt instruments with leverage features. Debt instruments structured in such a way that the return or losses to the investor may occur at multiples to their initial investment.

V.III. Structured deposits incorporating a structure making it difficult for the client to understand the risk of return

15. For the purpose of point (v) of Article 25(4)(a) of MiFID II, a structure making it difficult for the client to understand the risk of return should be interpreted as a structure and the related risk of return that an average retail client would be unlikely to understand readily.

This should be the case where:

a) more than one variable affects the return;

b) the relationship between the return and relevant variable is not simple; or

c) the variable is unusual or unfamiliar to the average retail investor in a relevant Member State.

V.IV. Structured deposits incorporating a structure making it difficult for the client to understand the cost of exiting before term

16. For the purpose of point (v) of Article 25(4)(a) of MiFID II, a structure making it difficult for the client to understand the cost of exiting before term should be interpreted as a structure and the related cost that an average retail client would be unlikely to understand readily.

17. This should be the case unless:

a) the exit penalty is a fixed sum;

b) the exit penalty is a fixed sum for each month (or part thereof) remaining until the agreed term; or

c) the exit penalty is a fixed percentage of the amount deposited.