



European Securities and
Markets Authority

Reply form for the Consultation Paper on draft guidelines on complex debt instruments and structured deposits



Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Consultation Paper on draft guidelines on complex debt instruments and structured deposits, published on the ESMA website.

Instructions

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

- use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
- do not remove the tags of type < ESMA_QUESTION_COMPLEX_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
- if you do not have a response to a question, do not delete it and leave the text "TYPE YOUR TEXT HERE" between the tags.

Responses are most helpful:

- if they respond to the question stated;
- contain a clear rationale, including on any related costs and benefits; and
- describe any alternatives that ESMA should consider

Naming protocol

In order to facilitate the handling of stakeholders responses please save your document using the following format:

ESMA_COMPLEXPRODUCTS_NAMEOFCOMPANY_NAMEOFDOCUMENT.

E.g. if the respondent were XXXX, the name of the reply form would be:

ESMA_COMPLEXPRODUCTS_XXXX_REPLYFORM or

ESMA_COMPLEXPRODUCTS_XXXX_ANNEX1

Deadline

Responses must reach us 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 end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that 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 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 headings 'Legal notice' and 'Data protection'.



Introduction

Please make your introductory comments below, if any:

< ESMA_COMMENT_COMPLEX_1 >

The Joint Associations Committee on Retail Structured Products (the “**JAC**”) welcomes the opportunity to comment on the issues set out in the ESMA Consultation Paper on draft guidelines on complex debt instruments and structured deposits (the “**CP**”). The JAC is sponsored by multiple associations with an interest in structured products, including the International Swaps and Derivatives Association (**ISDA**) and the International Capital Market Association (**ICMA**). We welcome 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 and the cost of exiting the product before term. We also believe that it is of utmost importance to 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.

We have addressed our responses to each of the questions posed in the CP which we believe are particularly relevant to the JAC and the concerns of its members. The JAC welcomes the opportunity to provide comments on the matters raised in the CP and we would be happy to engage in any further discussions that ESMA would find helpful to clarify or expand upon any of the points raised in our response.

The members of the JAC comprise many of the major firms (financial institutions and companies) involved in complex debt instruments and structured deposits. The JAC is, therefore, well placed to comment on the specific issues raised in the CP.

As innovation in financial markets has originally led to many financial products becoming increasingly complex, there is, and has been for a number of years, a focus on the ability for the clients to understand the risk of return and the costs of exiting products before term.

In addition, for packaged retail and insurance based investment products (“**PRIIPS**”), a consultation has already been carried out (which the JAC has responded to) in relation to how the risks of products should best be explained to clients as well as the costs of exiting a product early.

The JAC members note that “complexity” of debt instruments and structured deposits is defined by reference to “clients”. However, the CP does not clarify if such “clients” targeted are retail or sophisticated clients. The JAC members believe that tolerance to complexity should be defined by reference to the client’s sophistication. In addition, firms would request clarity on the definition of “average retail client” for the purposes of Section 1.3.

The JAC members note that ESMA acknowledges in Section 1.1 Para. 11 and Annex IV, Section I (2) and Section II (6) of the CP that the proposed criteria and resulting classification as either “complex” or “non-complex” should only be relevant with regard to the application of the appropriateness test (i.e., whether a product can be sold on an execution-only basis) as outlined in Article 25(4) of MiFID II and not taken as a universal definition of “complexity” for any other purposes. However, the JAC members note that it is important that any overlap with PRIIPS and with any other European Regulation or Directive is considered by ESMA when finalising these guidelines. In addition, based on the language set out in Section 1.1, Para. 7 and Annex IV, Section II (5) of the CP, the JAC members would welcome confirmation that the definition of embedded derivative will not be applied more widely throughout MiFID II.

We note the reference made in Section 1.1, Para. 10 of the CP to the product governance requirements as set out in Article 16(3) of MiFID II and the obligation for investment firms offering either debt instruments or structured deposits, as well as credit institutions selling or advising on structured deposits, 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. The JAC members would suggest



that ESMA clarify whether the identification of the target market might vary depending on the complexity of the relevant product. As set out in Para. 2.7(11) of ESMA's Technical Advice to the Commission on MiFID II and MiFIR (19 December 2014) (the "**Final Report**"), for more "plain vanilla" products, the target market identification process will be relatively simple. The JAC members would welcome clarity that whether a product is complex or non-complex might be one of the factors to take into consideration when determining the target market, although the JAC members would not advocate a "bright-line" test.

As an overarching comment, the JAC members would welcome the inclusion of a non-exhaustive list of those products which ESMA believes are non-complex (set out in Section 1.3, Para. 22 (i), (ii) and (iii)) within the Draft Guidelines set out under Annex IV of the CP.

< ESMA_COMMENT_COMPLEX_1 >

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?

<ESMA_QUESTION_COMPLEX_1>

As a general point, JAC members are concerned that classifying some of the products set out in the CP as embedding a derivative and, therefore, as complex would lead to a situation where products issued as securities are treated differently from those financial instruments with similar risk profiles and structures but which are in a different legal form.

In relation to the list of examples of debt instruments embedding a derivative and, therefore, automatically considered as “complex” set out in the CP, the JAC members have particular concerns about some of the instruments included in that list and how the fact that their inclusion in the list could affect the debt products available on the secondary markets.

Of particular concern is the inclusion of inflation-indexed bonds (Section 1.2, Para. 16(iv) of the CP) in the above mentioned list:

- The JAC members disagree with ESMA’s view that the correlation to the inflation rate should be considered as an “embedded derivative”. These instruments are typically structured such that the coupon is a base rate multiplied by the relevant inflation rate and the final redemption amount is also multiplied by the relevant inflation rate. The redemption amount is nonetheless typically subject to a floor of 100%, to rule out deflation, which would mitigate against complexity being an issue (in the sense of an average retail client not understanding what they have subscribed into and suffering a loss). We understand that ESMA believes that a bond where the repayment of the principal or the coupon amount varies with inflation should be considered as embedding a derivative; however, we believe that inflation-indexed bonds where the coupon only is linked to inflation should be classified in the same way as the CP classifies floating-rate notes (in Section 1.3, Para. 22(ii)), since the inflation rate acts only like a variable floating rate in effect. The JAC members do not believe that inflation as a variable is any more complex in itself than, for example, the London Interbank Offered Rate (“**LIBOR**”), which is a standard benchmark and “easy to understand”, as noted in the CP for floating-rate notes (in Section 1.3, Para. 22(ii)). In addition, it is not common for an inflation-indexed bond to pay a coupon (or not) depending on whether the inflation was in a certain range - which, in our view, would add a more derivative element to these type of instruments.
- If anything, we note that inflation-indexed bonds have been included in the section dealing with debt instruments embedding a derivative, rather than being considered in the section of instruments that incorporate a structure, making it difficult for the client to understand the risk. We believe that inflation-indexed bonds, when compared to the other items included in the section dealing with financial instruments embedding a derivative, are far simpler to understand for an average retail investor (i.e., they would understand the concept of “keeping pace with inflation”). We understand that the issue comes from the International Accounting Standards’ (“**IAS**”) or Article 10 of Directive 2007/16 Implementing Directive 85/611/EC (now Directive 2009/65/EC) definition of “transferable securities and money market instruments embedding derivatives” (see Section 1.2, Para. 13 and Annex IV, Section V.I(12) of the CP)). In the view of the JAC members, inflation indexed instruments should not fall within the definition and should be treated as non-complex.

<ESMA_QUESTION_COMPLEX_1>

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

<ESMA_QUESTION_COMPLEX_2>

Yes, the JAC members agree with the definition of “embedded derivative” and the relevant examples proposed in the CP. However, please refer to our considerations under Question 1 in relation to inflation-indexed bonds as well as our introductory comment seeking confirmation that the definition of embedded derivative will not be applied more widely throughout MiFID II.

<ESMA_QUESTION_COMPLEX_2>

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?

<ESMA_QUESTION_COMPLEX_3>

The JAC members note that the CP builds on the CESR 2009 Q&A on “MiFID complex and non-complex financial instruments for the purposes of the Directive’s appropriateness requirements” which suggests introducing the concept of a “structure making it difficult to understand the risk”, for all types of instruments, including money-market instruments. The JAC members share the view that this concept will improve investor protection, provided that the concept is correctly defined.

The JAC members also understand that the examples of debt instruments that incorporate a structure making it difficult for the client to understand the risk provided by ESMA in the CP only aim to address the aspect of the complexity of debt securities and not their risk. Indeed, we believe that it could be misleading to link “complexity” to “riskiness”. By way of example, the JAC members disagree with including “debt instruments structured in a way that may not provide for a full repayment of the principal amount” (Section 1.3, Para. 21(vii) and Annex IV, Section V.II (14)(f) of the CP) within the category of “debt instruments incorporating a structure making it difficult for the client to understand the risk”. The rationale behind our view is that we firmly believe that, for example, a Delta-One certificate linked to a share is not less complex than investing in a single share with capital protection.

The JAC members would invite ESMA to reconsider the inclusion of the following instruments within the list of examples of debt instruments that incorporate a structure making it difficult for the client to understand the risk:

Asset backed securities (Section 1.3, Para. 21(i) and Annex IV, Section V.II (14)(A) of the CP))

Firstly, asset-backed securities (“**ABS**”) are already subject to detailed and extensive existing regulation under the CRR, CRA 3 and many other regulations. The European Commission has sought comments from the industry¹ regarding a new “overarching framework” for securitisation that will amend, make consistent and consolidate the existing overlapping approach in securitisation regulation in one or more new instruments.

Secondly, the European Commission and many other leading policymakers, regulators and central banks have acknowledged the need to revive and rebuild “simple transparent and standardised securitisation”.

Thirdly, ABS share many of their features with covered bonds, which are included in the non-complex bucket under Section 1.3, Para. 22 (iii) of the CP. Both covered bonds and many securitisation structures serve a similar economic purpose in providing funding for bank lending. However, the special treatment provided for covered bonds, without corresponding treatment for certain securitisation structures which are structurally very similar and serve a similar economic purpose results in favourable treatment for those jurisdictions in which covered bonds are a widely used asset financing technique compared with those jurisdictions where traditional asset securitisation is more common and is not consistent with the general policy objective of achieving a “level playing field”.

For these reasons, the JAC members submit that securitisation ABS should be treated in a similar manner to covered bonds and should not be categorised as automatically complex².

We would suggest rewording Annex IV, Section V.II (14)(a) of the CP to exclude covered bonds and securitisation transactions.

Certificates (Section 1.3, Para 21(iii) and Annex IV, Section V.II (14)(B) of the CP)

¹ To which AFME responded on 13th May 2015. Available at <http://www.afme.eu/Documents/Consultation-responses.aspx>.

² Please refer to the AFME response to ESMA on Clearing Obligation under EMIR (No1) 18th August 2014, Paragraph 2.2.

We note that ESMA proposes to classify “Certificates” as defined in MiFIR as a form of subordinated debt and, therefore as complex products. The definition of “Certificate” in Article 2(1)(27) of MiFIR covers only specific equity or equity like instruments (and rank above equity but below unsecured bond instruments and other similar instruments). Paragraphs 56 to 59 of Section 3.1 of the Final Report clarify that there are a limited number of instruments which from ESMA’s analysis currently fall within this definition being Spanish Participaciones Preferentes, German Genusrechte/-scheine and Rabobank Certificates. It would be helpful if ESMA could clarify that only these limited scope of instruments (or future instruments with similar features) would be classified as complex products for the purposes of this paragraph.

Debt instruments with issuer discretion (Section 1.3, Para. 21(iv) and Annex IV, Section V.II (14)(c) of the CP)

The JAC members believe that all types of debt instruments have a certain element of discretion. We would invite ESMA (i) to clarify if by discretionary rights it means (as we believe) “change in the level of returns” (e.g. “flippable notes”); and (ii) to make clear that rights to deal with corporate actions, extraordinary events or tax, illegality events do not qualify for this purposes – otherwise a capital protected and/or fixed income note would also be deemed “complex” as these are common features to all debt instruments.

Debt instruments with an unfamiliar or unusual underlying (Section 1.3, Para. 21(vi) and Annex IV, Section V.II (14)(e) of the CP)

The JAC members do not agree that a debt instrument denominated in a currency which is not the one of the jurisdiction where the services are provided should be considered as a structure difficult for a customer to understand. Many retail customers are entirely familiar with major international currencies such as Euro, GBP and USD and it is common practice for retail clients to hold bank accounts in different currencies. Such a proposal will place firms on an unlevel playing field with regard to the provision of services and may restrict customer choice and access to products and providers situated in certain jurisdictions. For example, customers may be restricted to UK firms to trade GBP products and to Eurozone member firms to trade Euro products. This seems somewhat at odds with the principles of the passport and ability for firms to provide services on a cross border basis. It may also impact the availability of products denominated in major international currencies from firms based in all Member States, driving that business to third country product providers. Exchange rates are likely to be something many retail customers are entirely familiar with through the purchase of currency for international travel and they therefore have an understanding of how they work. The proposal to include these products in a list of complex products seems entirely disproportionate.

We would also invite ESMA to clarify the definition of “niche markets” (reference made in Section 1.3, Para. 21(vi) of the CP), by reference to what is to be considered “niche” in the relevant market.

Debt instruments issued by an SPV (Section 1.3, Para. 21(ix) and Annex IV, Section V.II (14)(h) of the CP)

We note that ESMA considers debt instruments issued by an SPV as instruments that, in certain circumstances, impair retail investors’ ability to fully understand the risk involved. We would suggest that the provision set out in Annex IV, Section V.II (14) (h) is deleted as such SPV issuances would likely be caught by the asset backed securities regime. However, if the provision is not deleted, we would have some observation on the proposed definition. We would invite ESMA to reconsider identifying “complexity” with the “denomination” of the debt instruments or the legal name of the SPV. In addition, we suggest that ESMA clarifies what is meant by “denomination” (i.e., as the actual face value of the product or, otherwise, its name). If the latter, we acknowledge that the denomination of an SPV might be misleading if it implies a higher credit standing than the real one. However, denomination does not constitute the reason of a debt instrument’s complexity. Instead, the collateralisation, asset segregation and limited recourse features may make a debt instrument difficult for the client to understand the risk. In particular, firms would welcome clarity that SPVs which are used to issue asset backed securities and/or are part of a wider group and are used for debt financing or treasury purposes for the group should not be caught within the SPV provision.

<ESMA_QUESTION_COMPLEX_3>

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?

<ESMA_QUESTION_COMPLEX_4>

We believe that it is important to underline that greater product complexity does not necessarily equate to greater product risk. Although we understand that the level of complexity and opaqueness of a financial product's term and/or structure will affect the ease with which the risk/reward profile attached to the product may be understood by a potential investor, recent experience suggests that a complex product may be less risky than a non-complex product. It is essential that the key risks of a complex products and an understanding of when a return is payable (or not) must be accessible to the investor; however, this increase in complexity does not necessarily require an appropriateness test, to the extent that the risks of a debt instruments remain easily accessible. Please see also our comments under "Question 3" above in relation to "complexity" and "riskiness".

We would suggest that ESMA includes within the Draft Guidelines at Annex IV, Section V.I.(12) of the CP a non-exhaustive list of those debt instruments which ESMA believes do not incorporate a structure making it difficult for the client to understand the risk (as set out in Section 1.3, Para. 22 of the CP).

<ESMA_QUESTION_COMPLEX_4>

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?

<ESMA_QUESTION_COMPLEX_5>

Yes, the JAC members agree with the definition of "a structure making it difficult for the client to understand the risk of return of structured deposits" and the relevant examples proposed in the CP.

However, we would invite ESMA to clarify the definition of "unusual or unfamiliar" variable to the average retail investor in a relevant Member State.

<ESMA_QUESTION_COMPLEX_5>

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?

<ESMA_QUESTION_COMPLEX_6>

We consider that disclosure might be an adequate way of dealing with the exit charges on structured deposits rather than automatically rendering them complex and we would invite ESMA to explore options in this regard.

<ESMA_QUESTION_COMPLEX_6>

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.

<ESMA_QUESTION_COMPLEX_7>

Please refer to our considerations as set out above.

The JAC members broadly agree with ESMA's view that most of the instruments listed will already be covered by the previous CESR guidance on complex financial instruments and therefore the new categorisation of complex/non-complex product introduced by the CP should not have a significant impact on the industry. However, we note that the previous CESR guidance on complex financial instruments only included (less sophisticated) guidance on instruments embedding a derivative element, without providing any further form of classification; whereas through the new categories of complex products introduced by ESMA the potential impact on the distribution of the debt instruments thereof included is much wider.



As set out above, we would recommend that ESMA:

- Clarify the degree of interaction between (i) the complexity of the product and (ii) the granularity of the target market identification obligations (as set out under Article 16(3) MiFID II), please see also under “Introduction” above; and
- In relation to specific categories of debt instruments: we would invite ESMA to consider and clarify the classification, in particular, of debt instruments issued by SPVs; asset backed securities; certificates; inflation-indexed instruments; debt instruments with an unfamiliar or unusual underlying; debt instruments structured in a way that may not provide for a full repayment of the principal amount; and debt instrument with issuer discretion.

<ESMA_QUESTION_COMPLEX_7>