



Date: 14 May 2009
Ref.: CESR/09-295

CONSULTATION PAPER

**MiFID complex and non-complex
financial instruments for the
purposes of the Directive's
appropriateness requirements**

Deadline for contributions: CESR invites responses to this consultation paper by **17 July 2009**. All contributions should be submitted online via CESR's website under the heading 'Consultations' at www.cesr.eu. All contributions received will be published following the close of the consultation, unless the respondent requests their submission to be confidential.



Table of contents

I	Introduction.....	3
II	Section 1 – Shares	7
III	Section 2 – Money market instruments, bonds and other forms of securitised debt	11
IV	Section 3 – UCITS and other collective investment undertakings.....	18
V	Section 4 – “Other non-complex financial instruments” under Article 38 of the Level 2 Directive: Issues of general interpretation.....	22
VI	Section 5 – Other products	26
VII	Section 6 – Conclusion.....	27
	ANNEX I – Summary list of MiFID complex / non-complex financial instruments	30
	ANNEX II – Extracts from MiFID Level 1 and Level 2.....	32
	ANNEX III - CESR’s technical advice on MiFID Level 2.....	35
	ANNEX IV – Extracts from the European Commission MiFID Q&A database	37



I Introduction

1. The Markets in Financial Instruments Directive (MiFID)¹ includes conduct of business requirements applying to a range of investment services. In certain respects, concerning investment firms' obligations to their clients and the information they must ask of clients, the approach and detail of these requirements differs according to the nature of the service; in particular whether or not the firm is providing investment advice to the client or is managing the client's portfolio on a discretionary basis.
2. Essentially, therefore, MiFID lays down three sets of requirements in this area:
 - (i) where a MiFID firm is providing investment advice or discretionary portfolio management, it must do so in accordance with the suitability requirements set out in Art. 19(4) of the MiFID Level 1 Directive and Articles 35 and 37 of the MiFID Level 2 Directive. These requirements are commonly referred to as the 'suitability test';
 - (ii) where a MiFID firm is providing investment services other than investment advice or discretionary portfolio management, it must do so in accordance with the appropriateness requirements set out in Art. 19(5) of the MiFID Level 1 Directive and Articles 36 and 37 of the MiFID Level 2 Directive. These requirements are commonly referred to as the 'appropriateness test'; and
 - (iii) as an exception to (ii), in certain prescribed circumstances, a firm may provide some investment services —reception-transmission and execution of orders— involving some types of financial instruments on an 'execution-only' basis, without having to apply the appropriateness test. These prescribed circumstances are set out in Art. 19(6) of the MiFID Level 1 Directive and Art. 38 of the MiFID Level 2 Directive.
3. This paper is concerned with the way in which the requirements described at (ii) and (iii) above apply to particular types of MiFID financial instruments. In this paper, (ii) and (iii) are collectively referred to as 'the appropriateness requirements', with the specific requirement described in (ii) referred to as the 'appropriateness test'.
4. The appropriateness test thus aims to increase the protection of clients (particularly retail clients) who are contemplating transactions in MiFID-scope financial instruments without receiving advice from the investment firm in question. It also aims to prevent complex products being sold on an 'execution-only' basis to retail clients who do not have the experience and/or knowledge to understand the risks of such products. In summary, where the appropriateness test applies, a firm must ask its client to provide information about their knowledge and experience relevant to the specific type of product or service in question, so that the firm can assess whether the product or service is appropriate for the client. A firm is required to determine whether that client has the necessary experience and knowledge in order to understand the risks involved in relation to the product or investment service offered or demanded, and to warn the client if the firm determines that the product or service is not appropriate for them.
5. The risk-based way in which the requirement applies, and what it should involve in each case, depends particularly on the nature of the client (i.e. whether retail or professional) and on the type of MiFID financial instrument that is involved in the transaction envisaged.
6. In terms of the type of instrument or financial product, the way in which the appropriateness requirements apply differs according to whether the instrument/product is deemed "non-complex" or "complex" for these purposes. In practical terms, this distinction matters because the appropriateness test must always have been undertaken by a MiFID

¹ This paper will make references to two Directives: the Level 1 Directive 2004/39/EC and the Level 2 Directive 2006/73/EC.



firm where the service or transaction involves a “complex” product. For “non-complex” products, the test does not need to be undertaken in certain specified circumstances - meaning that the resulting transactions can be carried out in a way that can be described as ‘execution-only’.

7. The Commission’s Background Note of February 2006 covering appropriateness, published to accompany its draft Level 2 Directive, included some helpful comments on the purpose of the distinction between complex and non-complex instruments. It commented that “for the purposes of the ‘execution only’ provisions in Article 19(6) of the Level 1 Directive, it is important to note that the complexity of a financial instrument per se is not necessarily synonymous with the risk associated with that instrument. Rather, complexity for the purposes of the Directive is determined by the way that an instrument is structured. This is because, typically, the level of complexity of a financial instrument’s structure will affect the ease with which the risk attached to the product may be understood. For example, all derivatives are assumed to be complex because their value is derived from another financial instrument or asset, adding a level of complexity to the understanding of the characteristics and valuation of those instruments.”
8. The MiFID Level 1 Directive (Art. 19(6)) lists specific types of instruments/products that can always be treated as non-complex for these purposes, then provides in the Level 2 Directive (Art. 38) a set of criteria for “other non-complex” products not specifically listed.² These provisions together also indicate some specific types of MiFID products that should always be treated as “complex” for the purposes of the appropriateness requirements. But MiFID does not seek to provide definitive or complete lists of all types of products and how they should be categorised, and since MiFID was agreed CESR and its members have received requests for clarification of how types of products might be categorised.
9. This paper therefore sets out for consultation CESR’s further analysis of types of MiFID financial instruments and its proposed views on how specific types of MiFID products are likely to fit within the complex/non-complex categories for the purposes of the appropriateness requirements.
10. The analysis and range of products considered cannot possibly be exhaustive or complete, given the number and variety of types of MiFID products traded in the world’s financial markets. Furthermore, the Level 2 Directive allows a firm to assume that a professional client has the necessary experience and knowledge in order to understand the risks involved in relation to those investment services or types of transaction or products for which the client is classified as a professional client. This paper therefore aims to focus on those MiFID products that are routinely or commonly transacted for retail clients, or where particular uncertainty may exist as to the treatment of products posing particular potential risks for retail clients.
11. CESR also wishes to stress the point that the appropriateness test is only one element of the requirements in MiFID relating to investment firms’ obligations to disclose and explain risks to their clients. For example, the Level 1 Directive includes a general requirement on firms³ to provide ‘appropriate information’, in a ‘comprehensible form’, about any MiFID ‘financial instruments and proposed investment strategies’; including ‘appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies’, so that clients are ‘reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument

² CESR’s Technical Advice to the European Commission on this point (CESR/05-290b, of April 2005) confirmed CESR’s view of the relationship between those instruments specifically listed in MiFID Art.19(6) as automatically non-complex and those other instruments that must be assessed against the criteria in what is now Art. 38 of the Level 2 Directive. CESR’s comments on this fundamental point are reproduced in the Annex to this paper.

³ Article 19(3)



that is being offered and, consequently, to take investment decisions on an informed basis'.⁴ The Level 1 Directive also includes⁵ a general obligation on an investment firm to “act honestly, fairly and professionally in accordance with the best interests of its clients” when providing investment services.

12. It is important that MiFID firms recognise such general obligations (to the extent relevant) in cases where the appropriateness test does not apply, particularly where the client is a retail client.
13. As indicated, this paper will focus only on issues arising from the first indent of Art. 19(6) of the Level 1 Directive, i.e. it will analyse the types of instruments that are specified in Art. 19(6) and the ‘other’ instruments that have to be assessed under Art. 38 of the Level 2 Directive. Other conditions to be satisfied in order for a service to be provided on an ‘execution only’ basis, such as the meaning of ‘at the initiative of the client’, the warnings to be provided to clients or the relevant conflicts of interest obligations arising under MiFID Art. 18 will not be addressed in this paper. Nor will this paper address other forms of complexity or leverage not intrinsic to the financial instrument itself, such as short selling or the borrowing of cash to finance the purchase of a financial instrument.
14. Firms should have sufficient policies and procedures in place to ‘ensure compliance of the firm including its managers, employees and tied agents with its obligations under the provisions of MiFID⁶, including those arising from Art. 19(6). Again, this paper is not concerned with what these policies and procedures should be.
15. Finally, the paper considers the scope of MiFID as it currently stands, in terms of the range of financial instruments covered by the Directive. It does not consider any possible future extension of the scope of application of MiFID standards (for example, as a result of any proposals from the European Commission).

Structure of this paper

16. This paper is structured as follows. Sections 1 to 4 consider the interpretation of each of the elements of the list of instruments in Art. 19(6):
 - Section 1 – shares;
 - Section 2 – money market instruments, bonds and other forms of securitised debt
 - Section 3 – UCITS and other collective investment undertakings; and
 - Section 4 – other non-complex financial instruments (including consideration of the criteria set out in Art. 38 of the MiFID Level 2 Directive).
17. Section 5 then considers certain other products not specifically covered elsewhere. Within each section, a question and answer approach is taken to consider the key questions and issues that arise. A number of consultation questions are also included, addressed to readers of the paper. Section 6 provides some conclusions from the exercise so far and a reminder of all the consultation questions.

Public consultation and timetable

18. CESR invites responses to this consultation paper. In addition to any general comments, we would appreciate receiving your views on the specific questions presented. All contributions shall be submitted online via CESR’s website under the heading Consultations at

⁴ Further detail on information to be provided to clients, including about the risks associated with financial instruments, is included in the Level 2 Directive (in particular, Articles 30-34).

⁵ Article 19(1) of the Level 1 Directive

⁶ Article 13(2) of the Level 1 Directive



www.cesr.eu by 17 July 2009.. An open hearing will be held in the CESR premises in Paris on 5 June 2009 to discuss the consultation paper with stakeholders.

19. CESR will consider the responses to the consultation and publish a final paper during the autumn of 2009. A feedback statement to the public consultation will also be published.

Impact assessment

20. This paper does not propose regulatory changes nor does it assess any past effects of previous regulatory interventions⁷. Its purpose is instead to consult on and clarify the application of requirements arising from the MiFID Level 1 and Level 2 Directives in respect of the instruments that can be classified as complex or non-complex for the purposes of the appropriateness test. We expect the Level 3 final document to increase legal certainty on these issues and promote greater convergence in interpretation, contributing to a level-playing field.
21. This consultation Paper has been prepared by the MiFID Level 3 Expert Group chaired by Mr Jean-Paul Servais, Chairman of the Executive Management Committee at the CBFA, and by its Sub-Group on Intermediaries, chaired by Mrs Maria Jose Gomez Yubero, Director at the CNMV. The rapporteur for this workstream is Diego Escanero (descanero@cesr.eu).

⁷ “IA [impact assessment] is a way of identifying whether or not there is a problem in the market, how serious it is, and whether or not the situation can be left to the market to resolve or can be improved upon through some form of regulatory response. It implies assessing the likely effects of proposed regulatory changes or the past effects of previous regulatory interventions”. Impact Assessment Guidelines, for EU Lamfalussy Level 3 Committees, April 2008, page 19.



II Section 1 – Shares

22. According to MiFID Level 1 Art. 19(6), shares admitted to trading on a regulated market or in an equivalent third country market are ‘non-complex’ instruments for the purposes of the appropriateness requirements. Any other types of shares that are not expressly mentioned in Art. 19(6) will have to be assessed as per the criteria in Art. 38 of the Level 2 Directive.

What is a regulated market?

23. A market falling under MiFID’s (Level 1 Art. 4(1)(14)) definition of ‘regulated market’. This can include investment exchanges and other types of multilateral markets regulated in accordance with MiFID Title III; it does not include those systems defined by MiFID as multilateral trading facilities (MTFs). Art. 47 of Level 1 requires that each Member State maintains an updated list of regulated markets for which it is the home Member State and communicates this information to other Member States and the European Commission. The Commission is required to publish a list of regulated markets, notified to it, on a yearly basis in the Official Journal of the European Union. The most recent list is in the Official Journal ref. 2008/C 280/03⁸.

What is an ‘equivalent third country market’?

24. Art. 19(6) states that ‘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’.
25. Since this list has not yet been published, there are no formal equivalent third country markets and there are two possible approaches to shares that are admitted to trading on a third country market:
- (i) either firms should assess such shares against the criteria in Art. 38 of the Level 2 Directive; or
 - (ii) in the absence of a list, all such shares would have to be treated as complex instruments.
26. Since one can assume that under the list, once published, some of these shares will be regarded as automatically non-complex and the others will need to be assessed against the Art. 38 criteria, CESR is inclined to the view that option (i) above is a more risk-based and proportionate approach until the list is published.

What types of shares are specifically covered under Art. 19(6) as being non-complex?

27. The answer to this question is not as straightforward as it might first appear. There are two key considerations here:
- MiFID does not define the specific term “shares”, either for the purpose of Art. 19(6) or elsewhere. Furthermore, this element of company law is not harmonised at the EU level;
 - however, in the definition of ‘transferable securities’ in MiFID Level 1 Art. 4(1)(18)(a), a distinction is made between “shares in companies and other securities equivalent to

⁸ Annotated presentation of regulated markets and national provisions implementing relevant requirements of MiFID (Directive 2004/39/EC of the European Parliament and of the Council): http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm



shares in companies, partnerships or other entities, and depositary receipts in respect of shares.”

28. This suggests that in interpreting the reference to shares in Art. 19(6), it could be read as capturing shares in companies where those shares are admitted to trading on a regulated market or an equivalent third country market, but excluding other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares. This would mean that shares in companies (when they are admitted to trading) would be automatically non-complex. Instruments other than such shares in companies admitted to trading would need to be assessed against the criteria in Art. 38 of the Level 2 Directive to determine whether they need to be treated as non-complex or complex instruments for the purposes of the appropriateness requirements.

Question 1: Do you have any comments on CESR’s view that Art. 19(6)’s reference to shares may best be read as capturing a particular range of shares and exclude other types of equity securities negotiable in the capital markets?

29. Two particular issues have arisen in CESR’s work with regard to the scope of the category of ‘shares’ for these purposes.
30. First, a case could be made that shares in a collective investment undertaking that takes the legal form of a corporate body should also be automatically non-complex, if those shares are admitted to trading on a regulated market. Since UCITS are separately mentioned in Art. 19(6) as automatically non-complex anyway, this is not an issue for shares in a UCITS, but it is for non-UCITS. Generally speaking, CESR members take the view for present purposes that these instruments are first and foremost collective investment schemes. This point prevails over the legal form that they take – special law prevails over general law. Therefore, they should be assessed against the criteria in Art. 38 of the Level 2 Directive, in the same way as units in non-UCITS open-ended and close-ended undertakings. This analysis provides a regulatory-neutral treatment of all types of non-UCITS.
31. The European Commission’s legislative proposals regarding the treatment of alternative investment funds, which will be published shortly, could helpfully address the above points.
32. The second issue is that CESR is aware that some differences remain between Member States as to the definition and precise specifications of preference shares or preferred stock in companies and, therefore, whether they should be treated as equity or debt⁹. In most Member States, preference shares (other than convertible preference shares – see below) are treated as corporate shares, they are admitted to trading as such and reported under the MiFID transparency obligations¹⁰. However, there are some preference shares which are callable after a period of time, and sometimes they are convertible into ordinary shares (see paragraph 34). These instances are examples of embedded derivatives in the preference shares, features that – when present – make them complex instruments (e.g. for the treatment of the Spanish securities participaciones preferentes, see paragraph 60.)

Question 2: Do you have any comments on the approach to different interpretations of the category of ‘shares’?

Question 3: Do you have any other comments on the discussion of shares under Art. 19(6) set out above?

⁹ Preferred stock is often regarded as a hybrid security with characteristics of both debt and equity.

¹⁰ Where a regulated market admits preference shares to trading, this is likely to be indicated in any list of instruments it publishes. The CESR database of shares admitted to trading on an EU regulated market includes preference shares.

How should other types of equity securities be treated?

33. All other types of equity securities that are not expressly mentioned in Art. 19(6) of the Level 1 Directive would have to be assessed against the criteria in Art. 38 of the Level 2 Directive. This includes:

- **Shares that are not admitted to trading on a regulated market or in an equivalent third country market.** This category would include ‘unlisted’ or ‘unquoted’ shares that are not admitted to trading on any public market, as well as shares admitted to trading on a market which is not a regulated market (or equivalent third country market).
- **Depository receipts for shares:** as noted above, the MiFID definition of transferable securities¹¹ distinguishes depository receipts in respect of shares (and bonds) from shares (and bonds) themselves.¹² This means that depository receipts admitted to trading on a regulated market are not identical to shares (or bonds) for these purposes and are therefore not automatically non-complex for the purposes of the appropriateness requirements¹³.
- **Stapled securities that comprise different types of security (one of which is a share)** which are ‘stapled’ i.e. are contractually bound to form a single unit so that they cannot be bought or sold separately. For example, we are aware that in some financial markets (e.g. Australia), it is common for property trusts to have their units stapled to the shares of companies with which they are closely associated. This may be less common in European markets, certainly involving retail clients, though CESR is aware of at least one issue within the EU involving ordinary shares and warrants being stapled.

Question 4: Do you agree that other equity securities should be assessed as per the criteria in Art. 38 of the Level 2 Directive?

Do listed convertible shares fulfil the Art. 38 criteria for being non-complex?

34. CESR believes that convertible shares (i.e. convertible preference shares or convertible preferred stock) would fall within the type of transferable securities described in Art. 4(1)(18)(c) of MiFID Level 1, as ‘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’. The types of securities covered by Art. 4(1)(18)(c) are expressly excluded from eligibility as “other non-complex financial instruments” under the Art. 38 criteria¹⁴. This means that convertible shares should be treated as complex products for the purposes of the appropriateness test. This outcome would be logically consistent with the Directive’s treatment of convertible bonds (see paragraph 57 below).

Question 5: Do you agree with CESR’s interpretation that convertible shares will always be complex under the appropriateness requirement as drafted?

¹¹ Art. 4(1)(18) of the Level 1 Directive

¹² At a simple level, a depository receipt can be defined as a type of transferable security representing another security (generally equity or debt) issued by a foreign listed company. The most common types of depository receipt are American Depositary Receipts (ADRs) and Global Depositary Receipts (GDRs)/European Depositary Receipts (EDRs).

¹³ This does not mean that these instruments cannot be treated as equivalent to shares for other regulatory purposes.

¹⁴ Article 38(a) of the Level 2 Directive.

Do subscription rights/nil-paid rights fulfil the Art. 38 criteria for being non-complex?

35. These are rights that give shareholders an opportunity to purchase more shares, usually at discount. They are usually given by the issuer of the original shares. The shareholders receive these rights at no cost, and if the rights are renounceable, the shareholders can choose to sell them on the market. The issuance of these rights is not a MiFID activity, but Art. 38 applies to MiFID activities such as the secondary trading of these instruments (i.e. when the shareholders choose to sell them).
36. Subscription rights/nil-paid rights could fall within the type of transferable securities described in Art. 4(1)(18)(c) of MiFID Level 1, as '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'. Since securities covered by Art. 4(1)(18)(c) are expressly excluded from eligibility as "other non-complex financial instruments" under the Art. 38 criteria, this means that subscription rights/nil-paid rights could be treated as complex products for the purposes of the appropriateness test.
37. Such a classification of subscription rights/nil-paid rights as complex products may however be problematic in practice and could be challenged. On the one hand, it may not be in the interests of the shareholder, given the usually very short timeframe within which it is necessary to make an investment decision regarding the rights, to risk slowing down or obstructing the shareholder's response, and it may be disproportionate to require an appropriateness test in circumstances where the shareholder has received the rights free of charge. On the other hand, it may be possible to analyse the rights not as a separate security but as a component of the share itself that is separated from the share only to facilitate the taking up and trading of the rights, so that it would be possible to treat the rights resulting from a share that is admitted to trading on a regulated market in the same way as the shares themselves.

Question 6: Do you agree with an interpretation that subscription rights/nil-paid rights for shares would be complex under the appropriateness requirement?

Question 7: Do you have any further comments on CESR's consideration of the position of shares?

Question 8: Are there other specific types of such instruments that should be explicitly mentioned in a list for the purposes of CESR's exercise?

III Section 2 – Money market instruments, bonds and other forms of securitised debt

38. MiFID Level 1 Art. 19(6) suggests that money market instruments, bonds and other forms of securitised debt are ‘non-complex’ instruments for the purposes of the appropriateness requirements, unless they embed a derivative. CESR sees the exception for instruments that embed a derivative as applying to all of these instruments, since all are forms of securitised debt.

What does the category of money market instruments cover?

39. Money market instruments are defined in MiFID Level 1 Art 4(1)(19) as those classes of instruments which are normally dealt in on the money market, such as:

- treasury bills;
- certificates of deposits; and
- commercial papers.

40. Q&A 167 in the European Commission’s MiFID Q&A database¹⁵ (see Annex III) expands on the Directive’s definition in commenting that “it is commonly understood that money-market instruments are liquid debt instruments that are capable of being traded (although in practice most are held until maturity). They usually mature in less than one year. The list of examples referred to in MiFID is not exhaustive (Article 4(1)(19) of Directive 2004/39/EC). Several EC Directives define “money market instruments”. Please see: Article 1(1) of Directive 85/611/EEC; Recital 4 of Directive 2001/108/EC; Recital 9 of Directive 2007/16/EC.” The Commission answer also references the ECB statistical framework which defines money market instruments as “those classes of transferable debt instruments which are normally traded on the money market (for example, certificates of deposit, commercial paper and banker’s acceptances, treasury and local authority bills)...” and which may be “issued by:

- a central, regional or local authority, a central bank of a Member State, the European Union, the ECB, the European Investment Bank, a non-Member State or, if the latter is a federal State, by one of the members making up the federation, or by a public international body to which one or more Member States belong; or
- an establishment subject to prudential supervision, in accordance with criteria defined by Community law or by an establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law, or guaranteed by any such establishment; or
- an undertaking the securities of which have been admitted to an official listing on a stock exchange or are traded on other regulated markets which operate regularly, are recognised and are open to the public.”

What does the category of treasury bills cover?

41. Treasury bills are traditionally short-term debt securities (with a maturity of less than one year) backed primarily by the U.S. government. However, it is clear from the context of MiFID and from the ECB discussion above that the reference to treasury bills should be read more widely than this, as covering securities issued or backed by any central, regional or local authority, a central bank of a Member State, the European Union, the ECB, the European Investment Bank, a non-Member State or, if the latter is a federal State, by one of the members making up the federation.

¹⁵ http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf



42. It is not clear whether a distinction is intended between short term securities (bills) and longer term securities (with maturities of greater than one year) which might better be regarded as government/public bonds. In practice, this question should not matter since both treasury bills and government/public bonds would be covered by the references in Art. 19(6) to money market instruments and bonds.

What does the category of certificates of deposits cover?

43. A certificate of deposit would be covered by MiFID where it is a transferable security, negotiable on the capital market. If it is not negotiable, then it would be excluded from MiFID as an instrument of payment.

What does the category of commercial paper cover?

44. Commercial paper has a common interpretation in the global money markets, basically as an unsecured promissory note with a fixed maturity of up to 270 days and variable interest rates, generally issued by credit institutions or large corporates. Regardless of the credit rating of the issuer (which will obviously determine the price and value of the instrument), MiFID would treat most commercial paper as automatically non-complex for the purposes of the appropriateness requirement. The exceptions to this would, in CESR's view, be commercial paper that embeds a derivative, and asset-backed commercial paper (see paragraphs 48 onwards below¹⁶), which CESR do not believe should be treated as non-complex instruments for the purposes of the appropriateness requirements. In any case, CESR does not believe that direct retail client investment in commercial paper is significant in Europe.

What types of money market instruments would be regarded as embedding a derivative and therefore complex instruments for the purposes of the appropriateness requirements?

45. CESR considers the concept of instruments that embed a derivative in paragraphs 52 and 53 below. Examples of common money market instruments that embed a derivative would include certain certificates of deposits or Medium Term Notes.

Question 9: Do you have any comments on CESR's view on the treatment of money market instruments?

Question 10 Are there other specific types of such instruments that should be explicitly mentioned in a list for the purposes of CESR's exercise?

Which types of instruments are included in this category as bonds and other forms of securitised debt?

46. In CESR's view, the reference to 'bonds' in Art.19(6) covers traditional bonds, where the bond-holder is in effect lender to the issuer and the issuer has to pay back the totality of the nominal value of the bond to the bond-holder at maturity. Such bonds usually have a defined term or maturity, after which the bonds are redeemed. Traditional bonds are in general issued by corporate bodies or public authorities.

¹⁶ Asset-backed commercial paper (ABCP) is a form of commercial paper that is collateralised by other financial assets. ABCP are typically short term investments that mature between 90 and 180 days – though they are generally rolled over to produce longer maturities. They are designed to be used for short-term financing needs for longer-term securities. Various structures exist for the issuance of ABCP. More detailed information, data and analysis is contained in Part II of CESR's December 2008 Consultation Paper entitled "Transparency of corporate bond, structured finance product and credit derivatives markets"; Ref: CESR/08-1014.



47. For the purpose of Art.19(6) CESR reads the term ‘securitised debt’ as meaning debt that is incorporated in a security. It then follows that the term ‘other forms of securitised debt’ means debt securities other than bonds or money market instruments.

Does this mean that all debt securities (bonds, money market instruments and other debt securities) are non-complex financial instruments?

48. No. CESR rejects the interpretation that reads the term ‘other forms of securitised debt’ as meaning debt that has undergone a securitisation process. Such an interpretation would reach a conclusion that makes instruments such as Mortgage Backed Securities (residential or commercial), Collateralised Debt Obligations, or other Asset Backed Securities (including those backed by e.g. auto-loans, credit card loans or equipment lease receivables) non-complex financial instruments.¹⁷
49. CESR takes the view that a number of types of securitised debt structures cannot accurately be described as ‘non-complex’, even where there may be a question as to whether or not they embed a derivative. Some of the examples of structures of Mortgage Backed Securities, Collateralised Debt Obligations, Asset Backed Commercial Paper and other Asset Backed Securities that are covered in the CESR Consultation Paper on “Transparency of corporate bond, structured finance product and credit derivatives markets”¹⁸ are good illustrations of the European Commission’s point (quoted in paragraph 7 of the present paper) that “complexity for the purposes of the Directive [MiFID] is determined by the way that an instrument is structured. This is because, typically, the level of complexity of a financial instrument’s structure will affect the ease with which the risk attached to the product may be understood. For example, all derivatives are assumed to be complex because their value is derived from another financial instrument or asset, adding a level of complexity to the understanding of the characteristics and valuation of those instruments.” In the same way, the value of Asset Backed Securities is derived from the assets that underlie them. The cash-flows and the ultimate cash settlement will also be determined by reference to these underlying assets, similarly to those types of transferable securities that are automatically complex for the purposes of the appropriateness requirements because they fall within MiFID Art.4(1)(18)(c). There are also similarities with the description of the characteristics of an embedded derivative quoted below in paragraphs 52 and 53.
50. Most retail clients will not be investing directly in most types of Asset Backed Securities (and certainly not without investment advice). However, given the structures of these instruments, the issues that have emerged in the financial markets involving Asset Backed Securities, and the involvement of some retail investors, CESR is of the view that Asset Backed Securities should not be regarded as non-complex instruments for the purposes of MiFID Art.19(6) and should not be transacted for retail clients on a non-advised basis without the appropriateness test being carried out – i.e. without a firm asking a retail client about their knowledge/experience to understand the risks and, if necessary, giving the client a warning.

Question 11: Do you have any comments on CESR’s view on the treatment of Asset Backed Securities?

Question 12: Do you think that this is a point on which MiFID could usefully be clarified?

51. CESR stresses that where firms are marketing debt instruments to retail clients they are under a MiFID obligation to provide appropriate information, in a comprehensible form, about these financial instruments and proposed investment strategies. This includes

¹⁷ CESR recognises that not all of these instruments are likely to be transacted by retail clients directly (as opposed to investment by funds in which retail clients may invest).

¹⁸ Ref: CESR/08-1014, December 2008.



appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies, so that clients are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis¹⁹.

Question 13: Do you have any other comments on CESR's view of the treatment of bonds and other forms of securitised debt under Art. 19(6)?

Question 14: Do you have any other comments on MiFID's treatment of 'other forms of securitised debt' for the purposes of the appropriateness requirements?

Is there a definition for bonds and other forms of securitised debt that embed a derivative?

52. MiFID does not include a definition of bonds and other forms of securitised debt that embed a derivative, either at Level 1 or Level 2. However, the concept of an instrument "embedding a derivative" is being increasingly used and discussed by bodies and groups that are active in the capital markets – notably those bodies involved in the development and setting of appropriate accounting standards.
53. CESR itself considered the concept in its advice to the European Commission on Clarification of Definitions concerning Eligible Assets for Investments of UCITS (January 2006, Ref: CESR/06-005). In formulating this advice, CESR took account of IAS 39²⁰, noting that "paragraph 10 of the IAS 39 defines an embedded derivative as "a component of a hybrid (combined) instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a standalone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable. A derivative that is attached to a financial instrument, but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument".

What types of instruments are included in this category?

54. CESR's advice on Eligible Assets for Investments of UCITS referred to above on Eligible Assets for Investments of UCITS also includes an "illustrative and non-exhaustive list" of financial instruments that CESR believes could be assumed to embed a derivative. This list comprises the following, all of which could be examples of money market instruments, bonds and other forms of securitised debt embedding a derivative:
- credit linked notes;²¹
 - structured instruments whose performance is linked to the performance of a bond index;

¹⁹ Art. 31 of the Level 2 Directive is particularly relevant in the context of debt instruments. For example, it includes the requirement that "in the case of financial instruments that incorporate a guarantee by a third party, the information about the guarantee shall include sufficient detail about the guarantor and the guarantee to enable the retail client or potential retail client to make a fair assessment of the guarantee."

²⁰ The objective of International Accounting Standard 39 is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

²¹ Essentially a security with an embedded credit default swap, allowing the issuer to transfer a specific credit risk to investors.

- structured instruments whose performance is linked to the performance of a basket of shares with or without active management;
- structured instruments with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares, with or without active management;

- convertible bonds; and

- exchangeable bonds.

55. Structured instruments whose performance is linked to the performance of another underlying such as a commodity or a commodity basket could also be added to this list.

Question 15: Do you have any comments on this analysis of instruments that embed a derivative and its relevance to the same concept in MiFID Art. 19(6)?

Why are money market instruments, bonds or other forms of securitised debt that embed a derivative always complex instruments for the purposes of the appropriateness requirements?

56. CESR believes that both a literal and risk-based reading of Art.19(6) leads to the conclusion that money market instruments, bonds and other forms of securitised debt that embed a derivative should not be categorised as “non-complex” for the purposes of the appropriateness test. If an instrument is explicitly excluded from the list of non-complex instruments in Art. 19(6), it should not be brought back in via Art. 38. Only those instruments not specifically mentioned in Art. 19(6) in the first place should be assessed against the criteria in Art. 38 as potentially “other non-complex financial instruments.”

What is the categorisation of convertible bonds?

57. As indicated in the illustrative list above, CESR believes that convertible bonds (and exchangeable bonds/reverse convertible bonds) can be regarded as bonds embedding a derivative and thus ineligible to be regarded as non-complex instruments for the purposes of the appropriateness test.^{22 23}

Are callable and puttable bonds non-complex or complex financial instruments for the purposes of the appropriateness test?

58. Callable bonds give the issuer of the bond the right to redeem the bond prior to the maturity date, under certain conditions. Puttable bonds (or put bonds) give the holder of the bond the right to force the issuer to repurchase the security before its maturity, under certain conditions. Each set of rights will be reflected in the coupon rate on the bond, and it is possible for a bond to embed both types of rights.

59. CESR recognises that it is reasonable to regard such callable bonds and puttable bonds as bonds embedding a call or put option, with the price of the bond taking these components into account. This would mean that such bonds would not be regarded as non-complex instruments for the purposes of the appropriateness requirements.

²² A convertible bond is an instrument that gives the holder the option to convert the bond for other securities (usually shares issued at the time of the conversion) offered by the issuer. An exchangeable bond (or reverse convertible bond) gives the holder the option to exchange the bond for securities of a company other than the issuer of the bond or for pre-existing securities of the issuer of the bond, at a future date under prescribed conditions.

²³ An alternative rationale is provided by the European Commission in its MiFID Q&A database, Q93. However, this also leads to the same conclusion that a convertible bond is a complex instrument for the purposes of the appropriateness test.

Question 16: Do you agree with CESR's view that it is reasonable to categorise callable and puttable bonds as complex financial instruments for the purposes of the appropriateness test?

What is the treatment of Spanish participaciones preferentes?

60. In Spain, securities called participaciones preferentes can be issued by credit institutions with features that make them akin to debt instruments that embed a derivative (because the issuer has the option to redeem them after 5 years, if this has been authorised by the Bank of Spain). They are therefore treated as complex instruments for the purposes of the appropriateness requirements.

What is the categorisation of covered bonds?

61. The term 'covered bond' is used for a number of financial instruments with different characteristics. Traditional covered bonds are corporate bonds with an enhancement in the form of a recourse to a ring-fenced pool of assets that remains on the balance sheet of the issuer. This pool of assets secures or "covers" the bond if the issuer (usually a financial institution) becomes insolvent. Issuers must ensure that the pool of assets consistently backs the covered bond. In case of insolvency, the investor has access to both the pool of assets and the issuer. CESR is of the opinion that these traditional covered bonds which include all of the above features are non-complex instruments as they are merely ordinary corporate bonds with an enhancement. CESR is also of the opinion that mortgage bonds issued by a credit institution under the conditions stated by Article 5(4)(b) of the Prospectus Directive should also be considered to be non complex instruments (see recital 13 of the implementing regulation of the Prospectus Directive).
62. However, structured covered bonds could be referred as bonds backed by a pool of assets which is off-balance sheet (held on a corporate structure separate from the financial institution). The issuer of these bonds is sometimes not the financial institution itself but the corporate structure that is wholly owned by the financial institution's group. These structured covered bonds are very similar to Asset Backed Securities and their regulatory treatment should be the same (see paragraphs 48 onwards above).

Question 17: Do you agree with CESR's distinction between traditional covered bonds and structured covered bonds? Is there a need for further distinctions in this space? If so, please provide details in your answers

What is the categorisation of subordinated bonds?

63. Although subordinated bonds have particular characteristics in the event of the bankruptcy or liquidation of the issuer, we do not believe that Art. 19(6) provides grounds to treat these as a further distinct category beyond those types of bonds or other securitised debt already mentioned. The same considerations should therefore apply to their categorisation as for other types of bonds and securitised debt. However, given the greater risks associated with subordinated bonds in terms of repayment in the event of insolvency, the general points made in paragraph 11 of this paper concerning risk disclosure are again particularly relevant.

What is the categorisation of depositary receipts in respect of bonds or other forms of securitised debt?

64. As with depositary receipts in respect of shares, the MiFID definition of "transferable securities" at Level 1 Art.4(1)(18)(b) distinguishes depositary receipts in respect of bonds or other forms of securitised debt from bonds or other forms of securitised debt themselves. It seems reasonable to read Art.19(6) in the same way. This would mean that depositary



receipts in respect of bonds or other forms of securitised debt would need to be assessed against the criteria in Art. 38 of the Level 2 Directive in determining whether they can be treated as non-complex instruments.

Other remarks

65. As our discussion of bonds and other debt instruments in this Section indicates, the considerations that are relevant to this category of instruments are less straightforward than the treatment under Art. 19(6) would suggest. The development of fixed income markets in the last decade on both volumes and complexity has been very significant, and it is doubtful that Art 19 (6) as it currently stands is a helpful starting point to achieve an appropriate degree of investor protection. Particularly given recent developments in the financial markets, CESR believes that the risks associated with these instruments, and therefore the risks faced by retail clients considering a transaction without taking advice, are likely to warrant a more differentiated approach than Art.19(6)'s listing of money market instruments, bonds and other forms of securitised debt . CESR encourages the EU institutions to rethink the approach to fixed income products under Art 19(6) and stands ready to help with technical advice if requested.

Question 18: Do you agree that there may be case to review MiFID's treatment of debt instruments for the purposes of the appropriateness requirements?

Question 19: Do you have any further comments on CESR's consideration of the position of bonds and other forms of securitised debt?

Question 20: Are there other specific types of such instruments that should be explicitly mentioned in a list of complex/non-complex financial instruments for the purposes of CESR's exercise?

IV Section 3 – UCITS and other collective investment undertakings

66. According to MiFID Level 1 Art. 19(6) UCITS are ‘non-complex’ instruments for the purposes of the appropriateness requirements. Other units in collective investment undertakings within the scope of Annex I to the MiFID Level 1 Directive will need to be assessed against the criteria in Art.38 of the Level 2 Directive.

What is a UCITS for the purpose of the appropriateness requirements?

67. There is no special meaning of the term "UCITS" for the purpose of the appropriateness requirements. The reference therefore captures investments in a collective investment undertaking which is constituted according to the UCITS Directive (Directive 85/611/EC, as amended).
68. UCITS may be constituted according to national law, either under the law of contract (as common funds managed by management companies), trust law (as a unit trust) or under statute (as investment companies). Depending on the form under which it has been constituted, a UCITS will be represented by units (when it is a common fund) or by shares (when it is a company). Art. 1 of the UCITS Directive furthermore confirms that the concept of units in collective investment undertakings also includes shares of such undertakings.
69. All investments in UCITS are non-complex instruments by definition, for the purposes of the appropriateness requirements, regardless of the underlying instruments in which the UCITS invests. Nothing in MiFID Art.19(6) requires a person to look through to the underlying investments of the UCITS for these purposes.

How should collective investment undertakings other than UCITS be classified for the purpose of the appropriateness requirements?

70. Units in collective investment undertakings that are not constituted according to the UCITS directive (‘non-UCITS’) are not all non-complex instruments automatically (see below).

When can a non-UCITS be categorised as a non-complex financial instrument?

71. Any unit or share in a non-UCITS collective investment undertaking can be categorised as a non-complex instrument if it fulfils all the criteria in Art. 38 of the Level 2 Directive.
72. The characteristics of a particular non-UCITS might also have an impact on whether it satisfies all the criteria in Art. 38. For example, some non-UCITS may be less likely to satisfy all the criteria of Art.38 (especially Art. 38, (b), (c) and (d)) if the undertaking itself is not authorised or regulated. On the other hand, if a non-UCITS is authorised for marketing to the public, this might have a bearing on its ability to satisfy the criterion that comprehensive information on its characteristics is publicly available in a form that is likely to be readily understandable by an average retail client.²⁴

What types of non-UCITS collective investment undertakings might be particularly relevant for the purpose of the appropriateness requirement?

73. Units (or shares) in all collective investment undertakings are financial instruments under MiFID Level 1 (Annex 1, Section C (3)), unless they are specifically excluded from the Directive’s scope (as, for example, insurance or pension products).

²⁴ The characteristics of the different instruments vary significantly, and the authorisation of a specific non-UCITS for marketing to the public does not automatically imply that the specific financial instrument satisfies the condition in Art. 38 (d). Firms must ensure that the condition is satisfied for the individual instruments offered on an execution-only basis.

74. Therefore, non-UCITS collective investment undertakings potentially covered by the appropriateness test requirement are those within MiFID scope that are not authorised in accordance with the UCITS Directive. This may cover undertakings which do not fulfill the requirements of the UCITS Directive or those that choose not to follow the UCITS route.
75. Non-UCITS can be regulated undertakings at national level or not (i.e. the schemes themselves can be authorised and regulated, or not, as well as their managers), and can be authorised for marketing to the general public, or not. Generally, non-UCITS can be more flexible than the UCITS with regards to the assets they can hold (e.g. some of them can hold property and can have direct exposure to commodities) and with regards to the way they spread risk and use leverage.
76. In October 2008, PricewaterhouseCoopers ('PwC') published a report for the European Commission on the subject of what it called 'non-harmonised' investment funds in the EU, which is relevant and informative on the issue of types of non-UCITS undertakings and retail client participation in them.²⁵ For the purposes of its analysis, PwC suggested four categories of non-UCITS/non-harmonised investment funds:
- real estate funds: providing investors with exposure to real estate investment; typically in the form of either open or closed-end funds;
 - private equity and venture capital funds: typically providing investors with the opportunity to invest in non-listed companies;
 - hedge funds and funds of hedge funds (if not constituted as UCITS); and
 - other non-harmonised (non-UCITS) funds: PwC describes this category as principally covering long-only funds for which promoters do not deem it necessary to comply with the UCITS Directive due to their distribution strategy/country of sales (e.g. domestic distribution) or investor types (e.g. institutional investors). It also includes funds which invest in assets which are not eligible for a UCITS.
77. PwC explains how regulation of these types of fund can vary between Member States, and restrictions that can apply (domestically, between States or both). It also considers common distribution models - at the time of the writing of the report - for non-harmonised funds, and the level of retail exposure to non-harmonised funds in nine Member States. On this last point, retail exposure was described as:
- highest for guaranteed funds (of the non-UCITS type);
 - moderate to low for the category of 'other non-harmonised funds', real estate funds and funds of hedge funds; and
 - lowest for private equity and venture capital funds, hedge funds, and other structured funds.
- Should an investment in a non-UCITS be categorized as a complex financial instrument simply due to the fact that it invests in derivatives or other complex financial instruments?*
78. CESR is of the opinion that the fact that a non-UCITS invests in derivatives or in other types of complex instruments will not automatically make units or shares in the undertaking itself complex, for the purposes of the appropriateness test. The categorisation of an investment in such an undertaking as a non-complex or a complex instrument will depend on the fulfillment or not of the criteria in Art. 38 of the Level 2 Directive.

²⁵ PricewaterhouseCoopers: 'The retailisation of non-harmonised investment funds in the European Union' (ETD/2007/IM/G4/95), October 2008.



79. Again, however, the general point made in paragraph 11 to this paper regarding explanation of risks may be particularly relevant here.

Question 21: Do you agree with CESR's view that non-UCITS undertakings should not automatically be categorized as complex instruments simply due to the fact that they invest in complex instruments?

How should undertakings such as Exchange Traded Funds (ETFs), capital protected funds or hedge funds be categorised?

80. ETFs which are structured as UCITS will be automatically non-complex. The treatment of ETFs which are non-UCITS will be as described in paragraphs 73 onwards above.
81. If a capital protected fund is an authorized UCITS, it will be categorized as a non-complex instrument by definition. Other types of capital protected funds will have to be assessed against the criteria in Art.38 of the implementing Directive.
82. Hedge funds are currently in the same position for these purposes, although a hedge fund is traditionally less likely to be a collective investment undertaking authorized under the UCITS Directive. However, since it is likely that in some cases such an undertaking will not itself be authorised or regulated and that it will not be permitted to market to the public without restrictions, it seems reasonable to consider that it may not readily satisfy the criteria in Art.38 of the Level 2 Directive where this is the determining factor.

Can the different treatments of units in collective investment undertakings be justified on policy grounds?

83. CESR agrees that a number of policy questions arise from the way in which Art. 19(6) has been drafted with respect to collective investment undertakings. For example:
- Should some non-UCITS be automatically complex? and
 - Should the MiFID approach be reviewed?

CESR believes that not all UCITS should be regarded as automatically non-complex. This is the manifestation of a more generic problem of the architecture of the rules in this space; MiFID Level 1 puts form over substance by setting in stone the qualification of certain financial instruments, regardless of their investment risk profile. On the other hand, MiFID Level 2 establishes qualitative criteria but liquidity and counterparty risk are not part of them.

84. The European Commission's legislative proposals regarding the treatment of alternative investment funds, which will be published shortly, will provide an opportunity for some of these issues to be considered further by all stakeholders.
85. Furthermore, CESR believes that national marketing and selling restrictions which address the marketing by the collective investment undertaking or its manager are out of the scope of the MiFID pursuant to Article 2(1)(h) MiFID. MiFID therefore does not prevent Member States from adopting certain provisions in this area; for instance requiring minimum subscription amounts for certain types of funds, prohibiting the sale of these funds to certain types of investors (e.g. retail investors) or their public distribution. The validity of these measures is however subject to the respect of the general provisions of the EC Treaty and other Community legislation. Member States are also able to restrict the marketing of units in non-harmonised collective investment undertakings to a certain target audience (e.g. by prohibiting the public marketing), as the regulation of marketing communications is outside the scope of MiFID.



Question 22: Do you agree with CESR's analysis of the treatment of units in collective investment undertakings for the purposes of the appropriateness requirements?

Question 23: Do you have any further comments on CESR's consideration of the position of these instruments?

Question 24: Are there other specific types of such instruments that should be explicitly mentioned in a list for the purposes of CESR's exercise?

V Section 4 – “Other non-complex financial instruments” under Article 38 of the Level 2 Directive: Issues of general interpretation

86. According to MiFID Level 2 Art. 38, other MiFID financial instruments which are not specifically mentioned in the first indent of Article 19(6) can be considered as non-complex instruments if they satisfy four criteria.
87. The four criteria to be satisfied by such an instrument are:
- (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.*
88. The need for these criteria is that it is not practical for the MiFID Level 1 Directive to attempt to list all types of financial instruments that may (now or in the future) reasonably be treated as ‘non-complex’ for the purposes of the appropriateness requirements. It therefore includes a reference to ‘other non-complex financial instruments’. CESR was asked by the Commission to advise on a set of criteria to guide the scope of this reference, which informed the Commission’s Level 2 Directive on this point.
89. Although there is room for interpretation on some of the criteria, the purpose of Art. 38 is to confine the scope of ‘other’ non-complex instruments only to those products that are adequately transparent, liquid and capable of being readily understood by retail clients. MiFID derivatives and certain similar instruments cannot qualify as ‘non-complex’ under the criteria.

Question 25: Do you agree with CESR’s view on the purpose of the Article 38?

Consideration of each criterion

38(a): The instrument 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

90. The first of the criteria (38.a) is quite direct. It has to be checked that the instrument does not fall within
- the types of derivatives contracts covered by MiFID, as listed at points (4) to (10) of Section C of Annex I to the Level 1 Directive; or
 - that part of the MiFID definition of transferable securities covering “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 4(1)(18)(c) of MiFID, Level 1).



91. This criterion prevents a large number of MiFID instruments from being treated as ‘non-complex’ for the purposes of the appropriateness test. It covers a wide range of futures, options, swaps, forward rate agreements, and financial contracts for differences.
92. In our view, the types of such MiFID instruments most likely to be commonly traded by retail clients as direct investments (as opposed to investments via funds), on a non-advised basis, include:
 - Warrants (see also Q.184 of the EC Q&A database)
 - Covered warrants²⁶ and
 - Financial contracts for differences (including financial ‘spread bets’, common in some Member States).

38(b) How often should a client have the opportunity to dispose, redeem or otherwise realise the instrument to consider that those opportunities are frequent?

93. We believe that the reference to frequent opportunities is capable of accommodating a range of frequencies: daily, weekly and, possibly, in the lesser amount of cases, longer regular frequencies.
94. Where the position may not be obvious, firms should consider this criterion on a case-by-case basis, taking account of information available, the particular instrument in question, and the standard practice in the markets for that instrument. For example, in the case of shares admitted to trading on non-regulated markets only, a number of venues support trading by market makers who are obliged to quote two way prices during the trading day - thereby ensuring that a market exists - and in some cases are subject to maximum spread restrictions. In such cases, the opportunity to trade is in theory there throughout the day.

Question 26: Do you agree with CESR’s interpretation of what constitutes frequent opportunities dispose of, redeem, or otherwise realise that instrument?

38(b) When are prices publicly available to market participants and how should prices be determined to meet the criterion?

95. In general we believe that prices are publicly available to market participants when they are easily accessible through channels that are easy to find for the relevant clients. For example, it may be considered that prices are publicly available when MiFID pre-trade and post-trade transparency requirements, or similar national requirements for financial instruments other than shares, apply.
96. Prices should be either market prices (i.e. prices at which a number of market participants are willing to trade and which are determined following transparent and non-discretionary rules), or (in the absence of market prices) prices made available, or validated, by valuation systems independent of the issuer. In our opinion, acceptable valuation systems for these purposes should be those which are generally recognised as being experts in providing such valuations and devoted to this activity on a consistent basis. These valuation systems must

²⁶ A covered warrant is a right to buy or sell an underlying asset (at or before a prescribed date at a specified price) that is issued by a third party, usually a financial institution. The warrants can be issued on any number of underlying securities, including single equities, a basket of shares, or a market index. The issuer of the warrant hedges their position using derivatives, such as traded options, and underlying shares; hence the term covered. A covered warrant can be cash-settled.

be independent of the issuer (and to this end firms should remember MiFID provisions on conflicts of interest).

97. In the case of units in non-UCITS, Recital 61 of the MiFID Level 2 Directive specifies the following with regard to criterion 38(b): ‘the circumstances in which valuation systems will be independent of the issuer should include where they are overseen by a depositary that is regulated as a provider of depositary services in a Member State’.

Question 27: Do you agree with CESR’s point of view on how prices should be determined and when it is considered that those prices are publicly available?

38(b) Does it mean that a product admitted to trading on a regulated market (other than shares) complies with the requirement of “frequent opportunities to dispose of, redeem, or otherwise realise that instrument”?

98. This will not automatically be so in every case. The admission to trading of the product offers the potentiality of having frequent opportunities to dispose of, redeem, or otherwise realise that instrument but does not ensure that in practice a range of frequencies will exist. Similarly, the existence of prices publicly available (determined either by the market or by valuation systems) in our opinion does not automatically ensure that Art.38(b) will be satisfied, if frequent opportunities to trade do not exist. Firms will need to be particularly diligent when considering securities trading on a market where liquidity is thin.²⁷

Question 28: Do you agree that the lack of liquidity could undermine the compliance with article 38(b)?

38(c) Under what circumstances can it be considered that the client has an actual or potential liability that exceeds the cost of acquiring the instrument?

99. The existence of an actual or potential liability can be understood as the possibility that, at any time, the investor runs the risk of being liable to make a payment above the initial outlay made in order to acquire the instrument, i.e. the cost of the financial instrument itself as well as the commissions and fees charged.

Question 29: Do you agree with CESR’s view? Do you think than any other clarification is required?

38(d) What does the information referred to in article 38 (d) cover?

100. It refers to adequately comprehensive information on the characteristics of a financial instrument. This is a wider concept than price (covered in criterion (b)), and potentially covers such points as the structure of the instrument, how the return is calculated, performance, the issuer, the market in the instrument, any guarantees, the risks, time horizons, and any other particular features that may affect the value, performance or liquidity of the instrument etc. The criterion also indicates the need for the client to have easy access to this information and that it should be described in a fair, clear and not misleading way.

38(d) When can it be considered that comprehensive information is publicly available?

²⁷ In this context, the definition of liquidity risk can be particularly relevant: the risk that a financial instrument cannot be purchased or sold without a significant concession in price because of the market’s potential inability to efficiently accommodate the desired trading size.

101. Information is publicly available when it is easily accessible through channels that are easy to find for the relevant clients. Some factors that could be considered to check the accessibility to the information are: number of sources through which information is available, the nature of the sources and channels, and the ability of the client to reproduce, download or print the information he needs. MiFID does not require an intermediary to create new information for the purposes of this criterion, if adequately comprehensive and understandable information is publicly available from other sources (including e.g. the issuer of the instrument). But if the firm is creating the information that is to be made publicly available, then the firm must ensure that it is fair, clear and not misleading and complies with any other applicable legal requirements.
102. A firm will also need to consider whether the language in which the comprehensive information is available will affect its ability 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.

Question 30: Do you agree with CESR's view on what constitutes comprehensive and publicly available information?



VI Section 5 – Other products

103. This section briefly considers certain other instruments or products that have not been explicitly considered in the previous sections of this paper.²⁸

Do the appropriateness requirements apply to deposits, loans, mortgages or life insurance products?

104. These questions have been addressed by the European Commission in its MiFID Q&A database. We have reproduced the relevant Q&As, 118 and 203, in Annex III to this paper.

105. In summary, the answer is “no” to all of the above, since these are not MiFID financial instruments listed in Section C to Annex 1 of the MiFID Level 1 Directive.

106. The exception to this is that the Commission regards a deposit with an embedded derivative that has the potential of reducing the initial capital invested as a financial instrument under MiFID.

What is the position of Exchange Traded Commodities (ETCs)?

107. CESR recognises that ETCs are increasingly traded by retail investors in a number of Member States. It is possible for these instruments to be structured in a number of ways. Some are structured in a way that combines features of contracts for differences and transferable securities. These investment instruments are sometimes listed on exchanges, but they have no specified maturity date and do not pay interest. The main element of return on the investment is an amount related to the price of a commodity, or level of a commodity index or indexes.

108. ETCs that are (in part) contracts for differences will need to be treated as 'complex' instruments for the purposes of the appropriateness test, since they do not satisfy the first condition of Art.38 of the Level 2 Directive.

109. Since different structures can exist, firms should consider the regulatory classification in each case for the purposes of the appropriateness test.

Question 31: Do you agree with CESR’s analysis of the position of these instruments?

Question 32: Are there other specific types of instruments that should be explicitly mentioned in a list for the purposes of CESR’s exercise? If so, please provide us with comprehensive information about the type of instrument(s).

²⁸ This assumes the current scope of MiFID and does not take account of any possible future extension of the scope of application of MiFID standards.

VII Section 6 – Conclusion

110. As this paper discusses, MiFID employs a distinction between ‘non-complex’ and ‘complex’ financial instruments as one element of the way in which its appropriateness requirements apply for non-advised investment services. The distinction matters in particular in relation to which services and which types of instruments may be eligible to be transacted on an “execution-only” basis for retail clients, without MiFID’s appropriateness test having to be satisfied.²⁹
111. MiFID did not attempt to provide a comprehensive and exhaustive list of how each type of financial instrument should be categorised. Nor does CESR attempt to do this in this paper. However, this paper does aim to provide helpful analysis, views and examples concerning how particular types of financial instruments might fall to be treated under the MiFID distinctions. CESR invites comments on its proposals and also on any further types of instruments that should be specifically mentioned in the exercise.
112. MiFID sought to take a risk-based approach in distinguishing between non-complex and complex instruments for these purposes. However, since MiFID was agreed, market conditions have altered the risk profile of many financial instruments, at least temporarily, occasionally making the investment risks associated with financial instruments less apparent to investors. Market developments have inevitably raised the question of whether parts of MiFID, including the appropriateness requirements, should be considered for review in some way. The paper suggests some areas where questions may particularly arise, and views are invited on both the specific areas pointed out in this paper and also the desirability of a general review of the MiFID treatment of financial instruments for the purpose of the appropriateness requirements more generally.
113. In addition, the paper highlights some specific issues of interpretation that arise from the way in which the list of instruments in MiFID Art.19(6) (and the associated Level 2 Directive) is drafted, and suggests how these issues may best be addressed.
114. CESR will consider the responses to the consultation and publish a final paper during the autumn of 2009.
115. List of consultation questions
- Question 1: Do you have any comments on CESR’s view that Art. 19(6)’s reference to shares may best be read as capturing a particular range of shares and exclude other types of equity securities negotiable in the capital markets?**
- Question 2: Do you have any comments on the approach to different interpretations of the category of ‘shares’?**
- Question 3: Do you have any other comments on the discussion of shares under Art. 19(6) set out above?**
- Question 4: Do you agree that other equity securities should be assessed as per the criteria in Art. 38 of the Level 2 Directive?**
- Question 5: Do you agree with CESR’s interpretation that convertible shares will always be complex under the appropriateness requirement as drafted?**

²⁹ The paper also aims to emphasise the point that the appropriateness test is only one element of the requirements in MiFID relating to investment firm’s obligations to disclose and explain risks to their clients.



- Question 6:** Do you agree with an interpretation that subscription rights/nil-paid rights for shares would be complex under the appropriateness requirement?
- Question 7:** Do you have any further comments on CESR's consideration of the position of shares?
- Question 8:** Are there other specific types of such instruments that should be explicitly mentioned in a list for the purposes of CESR's exercise?
- Question 9:** Do you have any comments on CESR's view on the treatment of money market instruments?
- Question 10:** Are there other specific types of such instruments that should be explicitly mentioned in a list for the purposes of CESR's exercise?
- Question 11:** Do you have any comments on CESR's view on the treatment of Asset Backed Securities?
- Question 12:** Do you think that this is a point on which MiFID could usefully be clarified?
- Question 13:** Do you have any other comments on CESR's view of the treatment of bonds and other forms of securitised debt under Art. 19(6)?
- Question 14:** Do you have any other comments on MiFID's treatment of 'other forms of securitised debt' for the purposes of the appropriateness requirements?
- Question 15:** Do you have any comments on this analysis of instruments that embed a derivative and its relevance to the same concept in MiFID Art. 19(6)?
- Question 16:** Do you agree with CESR's view that it is reasonable to categorise callable and puttable bonds as complex financial instruments for the purposes of the appropriateness test?
- Question 17:** Do you agree with CESR's distinction between traditional covered bonds and structured covered bonds? Is there a need for further distinctions in this space? If so, please provide details in your answers
- Question 18:** Do you agree that there may be case to review MiFID's treatment of debt instruments for the purposes of the appropriateness requirements?
- Question 19:** Do you have any further comments on CESR's consideration of the position of bonds and other forms of securitised debt?
- Question 20:** Are there other specific types of such instruments that should be explicitly mentioned in a list for the purposes of CESR's exercise?
- Question 21:** Do you agree with CESR's view that non-UCITS undertakings should not automatically be categorized as complex instruments simply due to the fact that they invest in complex instruments?



- Question 22:** Do you agree with CESR's analysis of the treatment of units in collective investment undertakings for the purposes of the appropriateness requirements?
- Question 23:** Do you have any further comments on CESR's consideration of the position of these instruments?
- Question 24:** Are there other specific types of such instruments that should be explicitly mentioned in a list for the purposes of CESR's exercise?
- Question 25:** Do you agree with CESR's view on the purpose of the Article 38?
- Question 26:** Do you agree with CESR's interpretation of what constitutes frequent opportunities dispose of, redeem, or otherwise realise that instrument?
- Question 27:** Do you agree with CESR's point of view on how prices should be determined and when it is considered that those prices are publicly available?
- Question 28:** Do you agree that the lack of liquidity could undermine the compliance with article 38(b)?
- Question 29:** Do you agree with CESR's view? Do you think than any other clarification is required?
- Question 30:** Do you agree with CESR's view on what constitutes comprehensive and publicly available information?
- Question 31:** Do you agree with CESR's analysis of the position of these instruments?
- Question 32:** Are there other specific types of instruments that should be explicitly mentioned in a list for the purposes of CESR's exercise? If so, please provide us with comprehensive information about the type of instrument(s).
- Question 33:** Do you have any further comments about this summary list of instruments?



**ANNEX I – Summary list of MiFID complex / non-complex financial instruments
(to be read in conjunction with the text of the paper)**

AUTOMATICALLY NON-COMPLEX UNDER ART. 19(6)	TO BE ASSESSED AGAINST THE CRITERIA IN ART.38 OF MiFID LEVEL 2 DIRECTIVE	ALWAYS COMPLEX UNDER ART.38 OF MiFID LEVEL 2 DIRECTIVE
1. SHARES		
<p>(i) Ordinary/ common shares in companies, admitted to trading on a regulated market.</p> <p>(ii) Ordinary preference shares in companies admitted to trading on a regulated market.</p>	<p>(i) Shares that are not admitted to trading on a regulated market.</p> <p>(ii) Shares admitted to trading on a third country market</p> <p>(iii) Depositary receipts for shares</p> <p>(iv) ‘Stapled securities’ that comprise a share and a different type of security.</p> <p>(v) Shares in non-UCITS open-ended collective investment undertakings</p> <p>(vi) Shares in non-UCITS close-ended collective investment undertakings</p>	<p>(i) Convertible shares.</p> <p>(ii) Subscription rights/nil-paid rights to acquire shares.</p> <p>(iii) Callable/convertible preference shares</p>
2. MONEY MARKET INSTRUMENTS, BONDS AND OTHER FORMS OF SECURITISED DEBT		
<p>(i) Money market instruments that do not embed a derivative. Including:</p> <ul style="list-style-type: none"> • Treasury bills • Certificates of deposit • Commercial paper • <p>(ii) Bonds that do not embed a derivative Including</p> <ul style="list-style-type: none"> • Corporate bonds • Government/public bonds • Traditional covered bonds 	<p>(i) Depositary receipts in respect of bonds or other forms of securitised debt.</p>	<p>(i) Money market instruments, bonds and other forms of securitised debt that embed a derivative. Including</p> <ul style="list-style-type: none"> • credit linked notes • structured instruments whose performance is linked to the performance of a bond index • structured instruments whose performance is linked to the performance of a basket of shares with or without active management • structured instruments with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares, with or without active management • Asset-backed securities (including e.g. mortgage-backed securities, CDOs) if they embed a derivative or are otherwise structured in a complex way • Structured covered bonds • convertible bonds

		<ul style="list-style-type: none"> • exchangeable bonds • callable bonds • puttable bonds • participaciones preferentes in Spanish credit institutions.
3. UCITS AND OTHER COLLECTIVE INVESTMENT UNDERTAKINGS		
<ul style="list-style-type: none"> • (i) Units (or 'shares') in any UCITS • 	<ul style="list-style-type: none"> • (i) Units in a non-UCITS fund. • (ii) Shares in a non-UCITS open-ended collective investment undertaking. • (iii) Shares in non-UCITS close-ended collective investment undertakings 	<ul style="list-style-type: none"> • None are automatically complex. (Note: the fact that an undertaking invests in derivatives will not automatically make it 'complex' for these purposes.)
4. OTHER FINANCIAL INSTRUMENTS		
N/A	Other MiFID financial instruments which are not specifically mentioned in the first indent of Art. 19(6) of the Level 1 Directive	<p>(i) MiFID-scope derivatives covered by items 4-10 of Section C of the Annex to MiFID</p> <p>(ii) Other securities giving the right to acquire or sell a transferable security or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measure (Article 4(1)(18)(c) of MiFID Level 1 Directive). Including</p> <ul style="list-style-type: none"> • Warrants • Covered warrants (It can be argued either that covered warrants fall under items 4-10 of Section C of the Annex I to MiFID or that they are securities covered by c) of article 4-1-18 of MiFID) • Financial contracts for differences (including e.g. Exchange Traded Commodities that are contracts for difference and financial 'spread bets')

Question 33: Do you have any further comments about this summary list of instruments?



ANNEX II – Extracts from MiFID Level 1 and Level 2.

116. *MiFID Art. 4.1(14)*

‘Regulated market’ means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments

- in the system and in accordance with its nondiscretionary rules
- in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III;

117. *MiFID Art. 4.1(18)*

‘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;

118. *MiFID Art. 4.1(19)*

‘Money-market instruments’ means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment;

119. *MiFID Art. 19 (4), (5) and (6)*

(4) When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him.

(5) Member States shall ensure that investment firms, when providing investment services other than those referred to in paragraph 4, ask the client or potential client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client.

In case the investment firm considers, on the basis of the information received under the previous subparagraph, that the product or service is not appropriate to the client or potential client, the investment firm shall warn the client or potential client. This warning may be provided in a standardised format.

In cases where the client or potential client elects not to provide the information referred to under the first subparagraph, or where he provides insufficient information regarding his knowledge and experience, the investment firm shall warn the client or potential client that such a decision will not allow the firm to determine whether the service or product envisaged is appropriate for him. This warning may be provided in a standardised format.

(6) 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.'

120. *MiFID Annex 1 Section C*

Financial Instruments

- (1) Transferable securities;
- (2) Money-market instruments;
- (3) Units in collective investment undertakings;
- (4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;
- (5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event); L 145/42 EN Official Journal of the European Union 30.4.2004
- (6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;
- (7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;
- (8) Derivative instruments for the transfer of credit risk;
- (9) Financial contracts for differences.
- (10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.

121. *Implementing Directive, Art. 38*

A financial instrument which is not specified in the first indent of Art. 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 they 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 judgement as to whether to enter into a transaction in that instrument.



ANNEX III - CESR's technical advice on MiFID Level 2.

122. *Extract from CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments. 1st set of Mandates where the deadline was extended and 2nd set of Mandates:*

“Article 19(6) uses the wording “other non-complex financial instrument”

whereas the mandate under Article 19(6) requires the determination of the criteria for what is to be considered as non-complex instrument. Assuming that a non-complex instrument must be a specific kind of a financial instrument, it has to fall within one of the categories of financial instruments mentioned in Annex I, Section C. Since money market instruments (Annex I, Section C 2) and UCITS (Annex I, Section C 3) are explicitly mentioned in Article 19(6) as instruments permitted for the service under Article 19(6), they have to be considered as non-complex. This conclusion is underlined by the fact that an investment firm is also allowed to provide the service under Article 19(6) in respect of “other” non-complex instruments. The reference to “other” could only mean that the aforementioned instruments are considered to be non-complex. Bonds and securitised debt are only admitted to the service under Article 19(6) when they do not embed a derivative.

The criteria provided in the advice are intended to provide the necessary flexibility for a wide range of existing and innovative financial instruments. However, CESR recognises that level 1 intends to exclude derivatives as financial instruments which are available for the service under Article 19(6).

The financial instruments that are expressly identified in the first indent of Article 19(6) of the Directive (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) and UCITS) are automatically non-complex financial instruments. The tests set out in this advice to determine whether financial instruments are non-complex therefore only apply to those financial instruments that are not expressly identified in the first indent of Article 19(6).”

123. *Implementing Directive, Recital 61*

For the purposes of determining whether a unit in a collective investment undertaking which does not comply with the requirements of Directive 85/611/EC, that has been authorised for marketing to the public, should be considered as non-complex, the circumstances in which valuation systems will be independent of the issuer should include where they are overseen by a depositary that is regulated as a provider of depositary services in a Member State.

124. *Extract from ‘CESR's Advice to the European Commission on Clarification of Definitions concerning Eligible Assets for Investments of UCITS’ (CESR 06-005, January 2006).*

Paragraph 120:

Paragraph 10 of the IAS 39 defines an embedded derivative as "a component of a hybrid (combined) instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a standalone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable. A derivative that is attached to a financial instrument, but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument".

Paragraph 121:

CESR is of the opinion that the definition of embedded derivatives provided in paragraph 10 of the IAS 39, as well as the first criteria set by paragraph 11 of the IAS 39, should be taken into account in the advice.

Box 11, Level 2:



“1. For the purpose of applying Art. 1(8) and 1(9) [of the UCITS Directive] in conjunction with Art. 21(3) 3rd subparagraph, a transferable security or a money market instrument embeds a derivative where it contains a component

- by virtue of which some or all of the cash flows that otherwise would be required by the transferable security or money market instrument which function as host contract can be modified according to a specified interest rate, financial instrument price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, and therefore vary in a way similar to a stand-alone derivative;

- whose economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract; and

- which has a significant impact on the risk profile and pricing of the transferable security or money market instrument in question.

2. For the purpose of applying Art. 1(8) and 1(9) in conjunction with Art. 21(3), a transferable security or money market instrument shall not be deemed to embed a derivative where it contains a component which is contractually transferable independently of the transferable security or the money market instrument. Such a component shall be deemed to be a separate financial instrument.

3. Given the three criteria developed above in paragraph 1, collateralized debt obligations (CDOs) or asset backed securities using derivatives, with or without an active management, will generally not qualify as SFIs embedding derivatives, except if:

- they are leveraged, i.e. the CDOs or asset backed securities are not limited recourse vehicles and the investors' loss can be higher than their initial investment; or

- they are not sufficiently diversified.

4. Where a product is structured as an alternative to an OTC derivative, its treatment should be similar to that of the OTC derivative instrument, if the consistency of the Directive provisions is to be ensured. This will be the case of tailor-made hybrid instruments, such as a single tranche CDO structured to meet the specific needs of a UCITS, should be considered as embedding a derivative from the Directive point of view. Such a product offers an alternative to the use of an OTC derivative, for the same purpose of achieving a diversified exposure with a pre-set credit risk level to a portfolio of entities.”

Box 11, Level 3:

5. In order to clarify the scope of the above definition, CESR considers appropriate to provide an illustrative and non-exhaustive list of structured financial instruments (SFIs) which could be assumed by a UCITS to embed a derivative:

- credit linked notes;

- SFIs whose performance is linked to the performance of a bond index;

- SFIs whose performance is linked to the performance of a basket of shares with or without active management;

- SFIs with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares, with or without active management;

- convertible bonds; and

- exchangeable bonds.”



ANNEX IV – Extracts from the European Commission MiFID Q&A database³⁰

Question 93

Is a convertible bond, under the directive, a complex product?

Answer to Question 93

The Commission states that “Convertible bonds are not mentioned expressly in the first indent of Article 19(6) of MiFID as non-complex products. Accordingly, it is necessary to apply the criteria in Article 38 of the implementing Directive (2006/73/EC). Point (a) provides that financial instruments can only be considered as non-complex if they do not fall within Article 4(1)(18)(c) of MiFID. Convertible bonds that give the right to acquire transferable securities do fall within that provision and are therefore complex products.”

Question 118

Do the following products fall under MiFID:

1. Term Deposits (in FX);
2. Term Deposit with embedded optionality;
3. Embedded options (e.g. swaps) on corporate loan;
4. mortgages offered to euro based customers that are denominated in FX;
5. Life insurance products (e.g. unit-linked) offered through bank branch?

Answer to question 118

A deposit is not a financial instrument as defined in MiFID, irrespective of the term or the currency in which it is denominated. This answer is based on the assumption that the question refers to a deposit per se, and not to a tradeable instrument such as a certificate of deposit and on the correct qualification of the contract in question as a deposit (i.e., an alleged deposit according to which the initial capital may be lost is not a deposit for the purposes of this answer).

In general, an option embedded in a deposit (such as an interest rate structure) does not change its classification as a deposit. An interest rate on a deposit may have features typical of a derivative without turning the deposit into a MiFID financial instrument. For instance, a floating rate of interest does not turn the deposit into a derivative contract.

Equally, a deposit with an embedded derivative that has the potential of reducing the initial capital invested is a financial instrument under MiFID.

The way the instrument is structured and documented is relevant. A fixed rate deposit coupled with a separate interest rate swap may in economic terms act in the same way as a floating rate deposit. However the separately documented interest rate swap in this example is still potentially a MiFID financial instrument while the floating rate deposit is not.

- The same approach applies to embedded options on corporate loans. An embedded option such as a facility to switch the method of calculating interest rates or to switch the currency of borrowings built into a loan that is not itself a security is not a financial instrument for the purposes of MiFID.

- Mortgages are not financial instruments as defined in MiFID, irrespective of the currency in which they are denominated.

- Life insurance products are not financial instruments as defined in MiFID. The fact they are distributed through entities that may be subject to MiFID does not affect this status.

Question 142

We are a portfolio management company (AMF approved). We manage real estate investment trusts [société civile de placement immobilier – SCPIs] and will soon also manage collective real estate investment undertakings [organisme de placement collectif immobilier – OPCIs]. We are currently working on the application of the MiFID Directive to the products that we manage. Could you please clarify for us whether the

³⁰ http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf



SCPI and the OPCI are considered as complex or non-complex products, as this is crucial for determining whether or not the tests of appropriateness apply.

Answer to question 142

If the SCPI and OPCI (as units in non-harmonised collective investment undertakings) are provided to investors, Article 19 of MiFID applies. When they are the object of investment advice or portfolio management, the suitability test in Article 19(4) has to be carried out.

For all other investment services (as referred to in Annex I Section A) an appropriate test pursuant to Art. 19(5) has to be undertaken. However, when the investment service of execution and/or transmission of orders is provided, an appropriateness test is not required if the conditions in 19(6) are fulfilled:

(i) One of these conditions is that the respective financial instrument is a so-called non-complex product pursuant to Art. 19 (6) first indent. With regard to SPCIs this is the case, if

the shares of the SPCI are admitted to trading on a regulated market (see Art. 4 (1)(14)) or in an equivalent third country market. Units in non-harmonised collective investment undertaking, by contrast to UCITS, are not expressly mentioned in Art. 19(6) first indent. They can, however, be so-called other non-complex financial instruments, provided that the four criteria set up in Art. 38 of the MiFID Level 2 Directive 2006/73/EC are met (whether units in non-harmonised collective investment undertaking meet these criteria needs to be checked in each individual case):

(ii) the service must be provided at the initiative of the client (on the meaning of this expression, see Recital (30) of the Level 1 Directive 2004/39/EC);

(iii) and he/she has been clearly informed that, in the provision of this service, the investment firm is not required to assess the suitability of the instrument. For eligible counterparties and professional clients, classified as such for the services or products in question, the appropriateness test need not apply: see Article 24(1) of Directive 2004/39/EC.

Question 167

According to Article 4(1)(19) of Directive 2004/39/EC money-market instruments means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposits and commercial papers and excluding instruments of payment. For level playing field issues and given that according to the branch of a UK credit institution, repurchase agreements (repos) and other money-market instruments are not included in the abovementioned definition. Could you please inform us which money-market instruments, other than savings and those clearly stated in the definition, fall under the provisions of MiFID?

Answer to question 167

It is commonly understood that money-market instruments are liquid debt instruments that are capable of being traded (although in practice most are held until maturity). They usually mature in less than one year. The list of examples referred to in MiFID is not exhaustive (Article 4(1)(19) of Directive 2004/39/EC). Several EC Directives define "money market instruments". Please see: Article 1(1) of Directive 85/611/EEC; Recital 4 of Directive 2001/108/EC; Recital 9 of Directive 2007/16/EC. Moreover, CESR's Advice to the European Commission on Clarification of Definitions concerning Eligible Assets for Investments of UCITS (CESR/06-005) contains a lot of references to money market instruments (<http://www.cesr.eu/index.php?docid=3694>). It specifies in paragraph 49 that according to the ECB statistical framework, money market instruments are defined as "those classes of transferable debt instruments which are normally traded on the money market (for example, certificates of deposit, commercial paper and banker's acceptances, treasury and local authority bills) because of the following features:

(i) liquidity, where they can be repurchased, redeemed or sold at limited cost, in terms of low fees and narrow bid/offer spread, and with very short settlement delay; and

(ii) market depth, where they are traded on a market which is able to absorb a large volume of transactions, with such trading of large amounts having a limited impact on their price; and

(iii) certainty in value, where their value can be accurately determined at any time or at least once a month; and



(iv) low interest risk, where they have a residual maturity of up to and including one year, or regular yield adjustments in line with money market conditions at least every 12 months; and

(v) low credit risk, where such instruments are either:

- admitted to an official listing on a stock exchange or traded on other regulated markets which operate regularly, are recognized and are open to the public, or
- issued under regulations aimed at protecting investors and savings, or
- issued by:
 - o a central, regional or local authority, a central bank of a Member State, the European Union, the ECB, the European Investment Bank, a non-Member State or, if the latter is a federal State, by one of the members making up the federation, or by a public international body to which one or more Member States belong; or
 - o an establishment subject to prudential supervision, in accordance with criteria defined by Community law or by an establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law, or guaranteed by any such establishment; or
 - o an undertaking the securities of which have been admitted to an official listing on a stock exchange or are traded on other regulated markets which operate regularly, are recognised and are open to the public".

Therefore, instruments which have the features described above are to be considered money market instruments.

Question 184

Do you consider share warrants and rights as complex products?

Answer to question 184

A warrant is a financial instrument falling under Article 4(1)(18)(c) of Directive 2004/39/EC, and as such must be considered a complex product according to the test in Article 38 of Directive 2006/73/EC.

Question 203

1. Do the requirements on information to be provided to the clients (specifically Article 19 of MiFID and Article 27 of implementing Directive) apply to the bank which is suggesting an investment product – structured deposit, where principal is guaranteed to the client, but potential return depends on the performance on certain financial index, bearing in mind the fact that such deposit is not explicitly included into the list of financial instruments in the Annex 1 of Mifid?

2. Do the requirements on information to be provided to the clients (specifically Article 19 of MiFID and Article 27 of implementing Directive) apply to the bank that is suggesting identical product, but designed as structured transferable note, where issuer guarantees nominal value to the client, but potential return depends on the performance on certain financial index?

Answer to question 203

1. No. A deposit is not a financial instrument as defined in MiFID, because it is not listed in Annex I Section C of Directive 2004/39/EC.

A deposit per se is not a tradable instrument and the initial capital cannot be lost

In general, an option embedded in a deposit (such as an interest rate structure) does not change its classification as a deposit. For instance, a floating rate of interest does not turn the deposit into a derivative contract.

See also answer to question 118 on Article 4(1)(17) of Directive 2004/39/EC.



2. Yes. A deposit with an embedded derivative that has the potential of reducing the initial capital invested is a financial instrument under MiFID.

See also answer to question 118.