Guidelines

Guidelines on complex debt instruments and structured deposits

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I. Scope

Who?

1. These guidelines apply to:

    a. competent authorities and

    b. firms.

What?

2. These guidelines apply in relation to Article 25(4) of Directive 2014/65/EU (MiFID II).

When?

3. These guidelines apply from 3 January 2017

II. References, abbreviations and definitions

Legislative references

AIFMD	Directive 2011/16/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Manager and amending Directive 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing an European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.
MiFID	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.
MiFID II	Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive

	2002/92/EC and Directive 2011/61/EU (recast).

Abbreviations

AIFM	Alternative Investment Fund Manager
CA	Competent Authority
CP	Consultation Paper
EC	European Commission
EU	European Union
ESMA	European Securities and Markets Authority
MiFID	Markets in Financial Instruments Directive

Definitions

4. Unless otherwise specified, terms used in MiFID IIhave the same meaning in these guidelines. In addition, the following definitions apply:

Firms	investment firms (as defined in Article 4(1)(1) of MiFID II), credit institutions (as defined in Article 4(1)(27) of MiFID II) when providing investment services and external AIFM when providing non-core services (within the meaning of Article 6(4)(a) and (b) of the AIFMD)
Debt instruments	bonds, other forms of securitised debt and money market instruments.

III. Purpose

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

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

7. ESMA expects these guidelines to strengthen investor protection and to promote greater convergence in the classification of “complex” or “non-complex” financial instruments or

structured deposits for the purposes of the appropriateness test/execution-only business in accordance with Article 25(3) and 25(4) of MiFID II.

IV. Compliance and reporting obligations

Status of the guidelines

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

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

Reporting requirements

10. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for non-compliance, within two months of the date of publication by ESMA to complexproducts1787@esma.europa.eu. In the absence of a response by this deadline, competent authorities will be considered as non-compliant. A template for notifications is available from the ESMA website.

11. Firms to which these guidelines apply are not required to report whether they comply with these guidelines.

V. Guidelines

V.I. Debt instruments embedding a derivative

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

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

13. For the purpose of points (ii) and (iii) of Article 25(4)(a) of MiFID II, debt instruments incorporating a structure making it difficult to understand the risk should include inter alia any of the following:

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

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

c) Debt instruments where the issuer enjoys discretion to modify the cash flows of the instrument. This category includes debt instruments structured in such a way that the anticipated revenue stream or repayment of principal is dependent on variables set by the issuer at its discretion.

d) Debt instruments lacking a specified redemption or maturity date. This category includes debt instruments structured in such a way that there is no specified maturity date and typically therefore no re-payment of the principal amount invested.

e) Debt instruments having an unusual or unfamiliar underlying. This category includes debt instruments structured in such a way that the anticipated revenue stream or repayment of principal is de pendent on variables which are unusual or unfamiliar for the average retail investor.

f) Debt instruments with complex mechanisms to determine or calculate the return. This category includes debt instruments structured in such a way that the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument either because certain pre-determined threshold conditions are met or because certain time-points are reached.

g) Debt instruments structured in a way that may not provide for a full repayment of the principal amount. This category includes debt instruments presenting a structure or subject to a mechanism which, in certain circumstances, trigger a partial repayment (or no repayment) of the principal.

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

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

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

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

14. For the purpose of point (v) of Article 25(4)(a) of MiFID II, a structure making it difficult for the client to understand the risk of return exists where:

    a) more than one variable affects the return received; or

    b) the relationship between the return and relevant variable or the mechanism to determine or calculate the return is complex; or

    c) the variable involved in the calculation of the return is unusual or unfamiliar to the average retail investor: or

    d) the contract gives the credit institution the unilateral right to terminate the agreement before maturity.

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

15. For the purpose of point (v) of Article 25(4)(a) of MiFID II, a structure making it difficult for the client to understand the cost of exiting the product before term exists where the exit cost is:

    a) neither a fixed sum;

    b) nor a fixed sum for each month (or part thereof) remaining until the end of the agreed term;

    c) nor a fixed percentage of the amount deposited.

V.V. Examples

16. The table in paragraph VI includes a non-exhaustive list of examples of debt instruments that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved and complex structured deposits for the purpose of Article 25(4)(a)(ii), (iii) and (v) of MiFID II.

VI. Table - Non exhaustive list of examples

Non-exhaustive list of examples of debt instruments that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved and complex structured deposits for the purpose of Article 25(4)(a)(ii), (iii) and (v) of MiFID II[1]

CATEGORY OF INSTRUMENT	(NON-EXHAUSTIVE) LIST OF EXAMPLES
DEBT INSTRUMENTS EMBEDDING A DERIVATIVE	a) Convertible and exchangeable bonds. b) Indexed bonds and turbo certificates. c) Contingent convertible bonds. d) Callable or puttable bonds. e) Credit-linked notes. f) Warrants.
DEBT INSTRUMENTS INCORPORATING A STRUCTURE MAKING IT DIFFICULT FOR THE CLIENT TO UNDERSTAND THE RISK	a) Debt instruments the return of which is dependent on the performance of a defined asset pool. Examples: Asset-backed securities and asset-backed commercial papers, Residential Mortgage Backed Securities (RMBS), Commerciale Mortgage Backed Securities (CMBS), Collateralised Debt Obligations (CDOs) b) Debt instruments the return of which is subordinated to the reimbursement of debt held by others. Examples: - subordinated debt instruments; - certificates (as defined under Article 2(1)(27) of MiFIR). c) Debt instruments where the issuer enjoys discretion to

[1] In some cases specific “types” of debt instruments have been identified, in other case a specific description has been provided. In some cases a financial instrument could fall into more than one category.

	modify the cash flows of the instruments. d) Debt instruments lacking a specified redemption or maturity date. Examples: - perpetual bonds. e) Debts instruments having an unusual or unfamiliar underlying. Examples: - Debt instruments referencing underlying such as non-public benchmarks, synthetic indices, niche markets, highly technical measures (including price volatility and combinations of variables); - catastrophe bonds. f) Debt instruments with complex mechanisms to determine or calculate the return. Examples: - debt instruments structured in such a way that the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument either because certain pre-determined threshold conditions are met or because certain time-points are reached. g) Debt instruments structured in a way that may not provide for a full repayment of the principal amount: - debt instruments eligible for bail-in tool purpose. h) Debt instruments issued by a special purpose vehicle (SPV) in circumstances in which the name of the debt instrument or the legal name of the SPV may mislead the investors as to the identity of the issuer or guarantor: i) Debt instruments with complex guarantee mechanisms. Examples: - Debt instruments with a guarantee mechanism where the trigger for the guarantee depends upon one or several conditions in addition to the default of the issuer; - Debt instruments with a guarantee mechanism where the level of guarantee or the actual trigger of the

	guarantee are subject to time limitations. j) Debt instruments with leverage features
STRUCTURED DEPOSITS INCORPORATING A STRUCTURE MAKING IT DIFFICULT FOR THE CLIENT TO UNDERSTAND THE RISK OF RETURN	Structured deposits, in cases where: a) More than one variable affects the return received. Examples: - Structured deposits where a basket of instruments or assets have to outperform a specified benchmark for a return to be paid; - Structured deposits where the return is determined by the combination of two or more indices. b) The relationship between the return and relevant variable or the mechanism to determine or calculate the return is complex. Examples: - structured deposits structured in a way that the mechanism under which the price level of an index is reflected in the return involves different market data points (i.e. one or more thresholds have to be met), or several index measurements at different dates; - structured deposits structured in a way that the capital gain or interest payable step up or down in certain specific circumstances; - structured deposits structured in a way that the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument. c) The variable involved in the calculation of the return is unfamiliar or unusual to the average retail investor. Examples: - Structured deposits where the return is linked to a niche market, an in-house index or other non-public benchmark, a synthetic index, or a highly technical measure such as asset price volatility. d) The contract gives the credit institutions the unilateral right to terminate the agreement before maturity

STRUCTURED DEPOSITS INCORPORATING A STRUCTURE MAKING IT DIFFICULT FOR THE CLIENT TO UNDERSTAND THE COST OF EXITING BEFORE TERM	Structured deposits, in cases where: a) An exit fee is not a fixed sum. Examples: - structured deposits having a variable or “capped” exit fee (i.e. a fee up to 300 euros is charged in case of early exit); - structured deposits referring a variable factor such as an interest rate for the calculation of the exit fee. b) An exit fee is not a fixed sum for each month remaining until the agreed term. Examples: - structured deposits having a variable or capped exit fee per month remaining until the agreed term (i.e. a fee up to 50 euro per month in case of early exit). c) An exit fee is not a percentage of the original sum invested. Examples: - structured deposits having an exit fee that is at least equal to the amount of the returns accrued until the early exit date.