Association française des marchés financiers
FINANCIAL MARKET PROFESSIONALS

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ESMA CONSULTATION PAPER
Guidelines on complex debt instruments and structured deposits
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AMAFI's contribution

1. Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI has more than 120 members operating for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives. Nearly one-third of its members are subsidiaries or branches of non-French institutions.

I. General comment – The necessity to clearly limit the scope of the guidelines to the application of the execution-only rule

2. Prior to answering the questions of the consultation paper (the CP), AMAFI would like to draw ESMA's attention on the necessity to clearly provide that the classification of a debt instrument as a "*complex security*" in these guidelines is only relevant for the application of the execution-only rule and must not be used for the implementation of other MiFID II and MiFIR requirements.

3. Indeed, the classification of a financial instrument as being complex may be used for the implementation of several MiFID II requirements. For instance, as regards the requirement to specify an identified target market (*MiFID II, art. 16.3*), the target market identification process will necessarily be different according to the nature and characteristics of the financial instruments. ESMA indicates in its technical advice to the European Commission that the target market identification process will be relatively simple for "*plain vanilla products*" (*Final Report, ESMA's Technical Advice to the Commission on MiFID II and MiFIR, 2.7, paragraph 11*).

Yet, it would be inappropriate to use the classification of a debt instrument as being complex or non-complex provided in these guidelines for the implementation of such a requirement.

4. Besides, there is a risk that these guidelines generate some confusion as several national competent authorities already use the notion of "*complex financial instruments*" for other purposes than the application of the execution-only rule. The French authority (the *Autorité des marchés financiers*) for instance issued in 2010 a *position* on the marketing of complex financial instruments (*AMF Position 2010-05*) which sets requirements not limited to the execution-only rule but also covering the assessment of the cost structure of a financial instrument and the suitability assessment. The scope of "*complex instruments*", which are mainly structured products, defined for this position is not at all the same as the one dealt with in the guidelines.

5. It is therefore important for ESMA to ensure that the classification of instruments as either complex or non-complex by the guidelines is not used for another purpose than determining whether or not an appropriateness test has to be performed by an investment firm when providing the investment services of execution or reception and transmission of client orders.

In this regard, the title of the guidelines should be amended as follows: "*Guidelines on complex debt instruments and structures deposits* ***for the purpose of Articles 25(3) and 25(4) of MiFID II***". Such a title would be more consistent with the scope of the guidelines.

II. Answers to ESMA's questions

A – Debt instruments embedding a derivative

Q1. Do you agree with the examples of debt instruments that are generally deemed to embed a derivative? If not, which examples do you not agree with, and why not?

6. AMAFI does not agree with the inclusion of callable and puttable bonds within the list of examples of debt instruments which embed a derivative, as the option granted to the issuer or holder of the bond to buy or sell this security is not a derivative.

According to the definition of "*derivatives*" provided by MiFIR, only the two categories of financial instruments "*defined in point (44)(c) of Article 4(1) of Directive 2014/65/EU; and referred to in Annex I, Section C (4) to (10)*" (*MiFIR, art. 2.1(29)*) are derivatives, and both categories only include options which are related to underlying assets such as securities, currencies or commodities.

By contrast, the option offered by a callable or a puttable bond is merely a right to amend the maturity date of the bond which is granted either to its issuer or to its holder. It is not an option related to an underlying asset.

7. Furthermore, the classification of puttable bonds as debt instruments requiring an appropriateness test in any circumstances could prove detrimental from an investors' protection perspective. Puttable bonds, which enhance their holders' protection by granting them the possibility to remit back to the issuer earlier than the maturity date, are usually offered by investment firms through the execution-only process. However, their classification as instruments embedding a derivative would reduce the incentive for investment firms to provide investment services on those instruments and consequently the retail clients' protection. .

8. Besides, as regards contingent convertible bonds, although AMAFI agrees that such debt instruments should be considered as embedding a derivative, the definition provided by ESMA is nonetheless too broad as it covers any debt securities the principal amount of which "*may be cancelled, reduced or converted into equity in certain circumstances*". Such a definition would include within the scope of contingent convertible bonds any debt instruments issued by a credit institution or an investment firm, as Directive 2014/59/CE establishing framework for the recovery and resolution of credit institutions and investment firms grants resolution authorities the power to convert eligible liabilities, which include bonds, of an institution under resolution into ordinary shares (*Directive 2014/59/UE, art. 63(1)(f)*). Resolution authorities are also granted "*the power to cancel debt instruments issued by an institution under resolution except for secured liabilities*" (*Directive 2014/59/UE, art. 63(1)(g)*)

Yet, it would be inappropriate to include within the category of instruments embedding a derivative any debt instruments issued by a financial institution, even plain vanilla ones, merely because a resolution authority could convert them into shares or cancel them in case of resolution of the institution. It would also be contrary to the MiFID II provision as the power for a resolution authority to convert or cancel bonds is not in itself a derivative.

It should therefore be clarified in the guidelines that only debt instruments which are issued as contingent convertible bonds must be considered as embedding a derivative.

Q2. Do you agree with the definition of embedded derivative proposed in the Guidelines in Annex IV? If not, why not?

9. Yes, AMAFI agrees with the definition of "*embedded derivative*" proposed by ESMA.

B – Debt instruments incorporating a structure making it difficult for the client to understand the risk

Q3. Do you agree with the examples of debt instruments that incorporate a structure making it difficult for the client to understand the risk? If not, which examples and why not?

10. No. AMAFI disagrees with several examples of debt instruments incorporating a structure making it difficult for the client to understand the risk which are listed by ESMA in the draft guidelines.

11. First of all, some confusion seems to be made between the complexity of a debt instrument's structure, the only criterion that should be taken into account according to the MiFID II provision, and the risks associated with a category of debt instruments. Indeed, while some debt instruments listed may be risky, their structures do not necessarily make those risks difficult to understand for a retail client.

As regards <u>subordinated debt instruments</u>, the sole difference between such securities and unsubordinated bonds is that holders of the former rank below holders of the latter, as do shareholders. Subordinated bonds are thus to some extent riskier than ordinary bonds, but this risk is not made difficult to understand by the product's structure.

In the same vein, even though various risks are associated with <u>perpetual bonds</u>, it is not clear why their structure makes these risks difficult to understand. The mere fact that a debt instrument has no maturity date should not *per se* be enough for its structure to be deemed complex. It is where the lack of maturity date is combined with another feature, for example the right for the issuer to recall the bond, that the structure is likely to make it difficult for retail clients to properly assess and understand the risks.

12. AMAFI has similar concerns about the following categories of instruments:

- <u>Debt instruments denominated in a currency which is not the one of the jurisdiction where the service is provided</u>

13. It is not adequate to consider that the category of debt instruments having an unusual or unfamiliar underlying includes bonds denominated in a currency different from the one of the jurisdiction where the investment service is provided. Actually, it is common for bonds offered to retail clients located in the European Union to be denominated in dollars, so that they are not debt instruments related to an unusual or unfamiliar underlying. Besides, if the fact that bonds are denominated in dollars could increase the risks depending on the clients' situations, the structure does not make these risks difficult to understand.

But above all, the inclusion of such securities within the list of complex securities would actually create discrepancies among retail clients within the European Union as a bond issued in euros would be considered complex when offered to an English retail client and non-complex when offered to a retail client located in France or Germany. Inversely, bond denominated in the currency of a Member State which has not adopted the euro as its official currency, such bonds denominated in sterlings or Swedish kronas, would be considered complex when offered to retail clients located within the Eurozone and non-complex for retail clients located in that Member State. From an operational perspective, the consequence could be that some investment firms with clients located both inside and outside the Eurozone will likely consider that all bonds regardless of the currency they are denominated in are complex for their retail clients.

- Debt instruments that would be regarded as package product

14. The classification of a debt instrument as complex for the purpose of the execution-only rule should not be based on whether it is a PRIIP or not. While the performance of an appropriateness test and the delivery of a KID (Key Information Document) both aim to strength retail clients's protection, the scope of these obligations are different.The PRIIPs Regulation was designed to increase and improve information delivered to retail clients on a wide range of package products regardless of their degree of complexity, so that debt instruments for which the drawing up of a KID will be required should not automatically be classified as complex for the purpose of the execution-only rule.

- Debt issued by a special purpose vehicle where the denomination of the instrument or the SPV may mislead the investors as to the identity of the issuer or guarantor

15. If AMAFI agrees with ESMA that debt instruments issued by an SPV may, in certain circumstances, impair the clients' ability to fully understand the risks involved, the denomination of such instruments or the legal name of the SPV should not be considered as a circumstance increasing the difficulty for a retail client to properly assess the risks associated with these instruments.

The fact that an SPV uses in its legal name the name of a credit institution or an investment firm, if they belong to the same financial group, is not meant to create confusion but to offer clarity to retail investors on the financial strength of the SPV's guarantor. Hence, it should be clearly stated that the situations where the SPV' legal name uses the name of the guarantor are not considered as being misleading and requiring the performance of an appropriateness test.

- Debt inbstruments with a complex guarantee mechanism

16. It should be made clear that where a guarantee includes collateralised assets the sale of which is required prior to calling the guarantor, in case of bankruptcy of the issuer, the performance of an appropriateness test is not required. Such guarantee mechanisms are actually designed to increase the protection of investors through the use of collateralised assets, in addition to the guarantor, so that classifying debt instruments with this kind of guarantee mechanisms as having a structure making the risk difficult to understand would be detrimental for retail clients.

Q4. Do you agree with the definition of a structure making it difficult for the client to understand the risk included in the Guidelines in Annex IV? If not, why not?

17. No. AMAFI has some concerns about the proposed definition as it is not clear which instruments will be considered as having a structure making it difficult to understand the risk for an "*average retail client*" due to the lack of definition of this notion. Indeed, an "*average retail client*" is neither defined nor used in MiFID II and MiFIR.

It is not only used in the provision related to the in the current MiFID Implementing Directive, but again without being defined which has raised some questions about its scope.

For the sake of clarity, AMAFI therefore recommends that this notion be deleted from the guidelines and that it simply be referred to the notion of "*retail clients*" instead. If the notion of "*average retail client*" was nevertheless to be retained, it would be useful that ESMA defines it.

18. Furthermore, AMAFI agrees with ESMA's interpretation that a debt instrument the characteristics of which differ **substantially** from those of ordinary bonds should be considered as having a structure likely to make the risks associated with it not readily understandable for retail clients. However, it appears from the examples proposed in the CP that the performance of an appropriateness test would be required for debt instruments which do not substantially differ from ordinary bonds. Coming back to the example commented in Q3, it is not clear for example why a "*plain vanilla*" bond issued in a currency which is not the one of the jurisdiction where the investment service is provided should always be considered as having characteristics differing substantially from those of an ordinary bond.

According to AMAFI, a more balanced approach would be to require investment firms to determine whether a debt instrument which has one or several characteristics listed in the guidelines as being likely to make it difficult for retail clients to understand the risks is substantially different from an ordinary bond.

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

Q5. Do you agree with the definition of a structure making it difficult for the client to understand the risk of return of structured deposits and with the relevant examples proposed? If not, why not?

19. AMAFI agrees with the definition of a "*structure making it difficult for the client to understand the risk of return of structured deposits*" proposed by ESMA in the draft guidelines.

Nevertheless, as regards the proposed relevant examples, as for debt instruments (*see answer to Q3*), it is not adequate to consider that the category of structured deposits with an unusual or unfamiliar variable includes structured deposits the return of which is dependent on a currency different from the one of the jurisdiction where the structured deposit is offered.

20. Besides, AMAFI disagrees with ESMA's proposal that the assessment of a structured deposit's complexity be based on whether or not the variable is unusual or unfamiliar for the average retail investor "*in a relevant Member State*". It would create discrepancies between retail investors within the European Union, contrary to the purpose of guidelines which to ensure a uniform and consistent application of Union law, so that the expression "*in a relevant Member State*" should be deleted.

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

Q6. Do you agree with the definition of a structure making it difficult for the client to understand the cost of exiting a structured deposit before term and with the relevant examples proposed? If not, why not?

21. Yes, AMAFI agrees with the definition of a "*structure making it difficult for the client to understand the cost of exiting a structured deposit before term*" and the relevant examples proposed in the draft guidelines.

E – Potential impact of the guidelines

Q7. Please provide any specific evidence or data that would further inform the analysis of the likely cost and benefit impacts of the guidelines?

22. AMAFI is not in a position to provide data on the likely cost and benefit impacts of the guidelines.