

## Opinion

### MiFID practices for firms selling complex products

#### Legal basis

1. ESMA's competence to deliver an opinion is based on Article 29(1)(a) of Regulation (EU) No 1095/2010 of the European Parliament and of the Council<sup>1</sup> (the 'ESMA Regulation'). In accordance with Article 44(1) of the ESMA Regulation ('Decision making'), the Board of Supervisors adopted this opinion on 5 November 2013.

#### Background

2. The marketing and sale of complex products, in particular to retail investors, remains a key concern for ESMA. Due to (i) low returns from more traditional forms of investments or ordinary deposits, and (ii) volatility in the markets, investment firms ('firms') have responded to demand for higher yields by making alternative and more sophisticated investment strategies available to retail clients, often through complex investment products (including structured products). These complex products allow retail investors access to asset classes, market segments and investment strategies that were previously only available to professional clients.
3. From an investor protection perspective, this trend poses certain risks for retail investors: due to their complexity, they may not be able to understand the risks, costs and expected returns of some complex products and/or the drivers of risks and returns. This hampers their ability to make informed investment decisions, and increases the likelihood of consumer detriment (for example, unexpected losses).
4. ESMA's Committee for Economic and Markets Analysis (CEMA) has also undertaken some work on complex products over the past few years with regard to two main aspects (i) the sale of structured products to retail investors, and (ii) UCITS pursuing alternative investment strategies ('alternative UCITS'). The report<sup>2</sup> on this work was published in July 2013.
5. Furthermore, ESMA's work on foreign exchange, online dealing/broking, and auto-trading issues (for example) has also highlighted issues relating to complex products and related services. Several national competent authorities (NCAs) have raised investor protection concerns as a result of the increase in the selling of a variety of complex products (including contracts for difference 'CFDs') to retail investors.

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<sup>1</sup> Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

<sup>2</sup> "Economic Report - Retailisation in the EU - No. 1, 2013".



6. ESMA is concerned that although the existing MiFID<sup>3</sup> and MiFID Implementing Directive<sup>4</sup> requirements<sup>5</sup> should be sufficient, if correctly applied, supervised and enforced, it appears that compliance standards for the MiFID conduct of business rules (on information to clients, suitability and appropriateness - in particular) may have fallen short in a number of cases.
7. The marketing and sale of complex products, in particular to retail investors, is an important investor protection area in which we can improve supervisory convergence by emphasising the application of the MiFID conduct of business rules - especially in an era of (i) growing complexity in financial instruments, and (ii) the increasing use of the internet (both by providers to approach investors, and by investors to access products).
8. Without prejudice to any legislative initiatives being undertaken by the European Institutions, ESMA is issuing this opinion to remind supervisors about the relevant MiFID provisions governing selling practices (conduct of business rules). NCAs, in carrying out their supervisory duties, should monitor that firms observe the practices described in this opinion when selling complex products on both an advised and non-advised basis.

### **ESMA's opinion**

9. For the purposes of this opinion, complex products/financial instruments are those that do not meet the criteria of “non-complex” as set out in Article 19(6) of MiFID and Article 38 of the MiFID Implementing Directive.<sup>6</sup> Financial instruments with structures that make the risks and likelihood of return more difficult to understand, including platforms giving access to complex products, are also likely to be considered ‘complex’.

#### *Types of “complex products”*

10. Complexity is a relative term, and depends on the risk-reward profile and other characteristics of the product. ESMA is of the opinion that products should generally be considered as ‘complex’ when:
  - (i) they are derivatives, or embed a derivative; and/or
  - (ii) they are made up of one or more underlying financial instrument(s) that are difficult to value, or are combined in such a way so as to make it difficult to assess the risks involved and the likely performance scenarios; and/or
  - (iii) they use more opaque indices that are for example set up by the product manufacturer, rather than using standard market indices; and/or

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<sup>3</sup> 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.

<sup>4</sup> Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

<sup>5</sup> For example, on disclosure, suitability and appropriateness – see MiFID Article 19, and the MiFID Implementing Directive Articles 27, 29, 31, 33, 35, 36, and 37.

<sup>6</sup> That is, while complex/ity is not defined in MiFID, what is considered complex is everything that is not “non-complex”, which is defined in MiFID. See also: MiFID complex and non-complex financial instruments for the purposes of the [MiFID] Directive’s appropriateness requirements [CESR/09-559].

- (iv) have a fixed investment term of a number of years with barriers to exit (that are not clearly explained) - whether that is due to the lack of a secondary market, or significant penalties or losses on early exit; and/or
  - (v) have returns/pay-off structures involving multiple variables or complex mathematical formulas; and/or
  - (vi) include capital protection that may be conditional or partial, or that can be withdrawn on the occurrence of certain events.
11. The following specific products should be considered as examples of complex products: contracts for difference (CFDs); binary options; turbos; exchangeable bonds; callable bonds; puttable bonds; convertible bonds; perpetual bonds; subordinated bonds; warrants; certificates; derivatives relating to underlying securities, currencies, interest rates, yields, or commodities; credit linked notes; and asset-backed securities. Overall, the vast majority of structured products can be considered as complex products.

#### *MiFID practices for firms selling complex products*

12. The more complex a product, the harder it is to demonstrate that retail clients have sufficient financial knowledge and experience to understand the key features, benefits and risks involved in an investment.

#### Organisation/internal control

13. When carrying out their supervisory duties, NCAs should monitor that firms have in place adequate internal controls for products and services development when providing clients (both retail and professional) with investment services in complex products, in order to avoid detrimental practices toward clients.
14. If, following firms' due diligence, it appears that a particular complex product will never meet the best interests of their clients, or there is a lack of sufficient information available to ascertain the main features and risks of a product, NCAs should monitor that firms do not offer advice on that envisaged product, or sell it at all.
15. As MiFID requires firms to act in the best interests of its clients, NCAs should monitor that trading platforms that give access to complex products only market complex products to those clients for whom they would be potentially suitable, or appropriate (where the client would possess the necessary level of knowledge and experience).
16. NCAs should monitor that firms ensure that those responsible for the establishment of the target market, drafting of marketing material and provision of investment services to clients, fully understand the nature and workings of the complex product envisaged. This is particularly relevant in the case of new products or variations to existing services provided by firms.
17. NCAs should monitor that firms make sure, through adequate training, that staff possess the skills, knowledge and expertise necessary, including sufficient knowledge of the relevant regulatory requirements and procedures, to be able to assess the needs and circumstances of the client (both retail and professional) and have sufficient expertise in financial markets to understand the financial

instruments to be sold, and to determine when the features of the product match the needs and circumstances of the client.

18. NCAs should monitor that firms consider whether the complex product should be sold on an advised or non-advised basis to their target market. In their supervisory practices, NCAs should consequently monitor that firms assess their non-advised sales of complex products to clients to ensure that their categorisation of these clients (i) is robust and regularly monitored, and (ii) correctly reflects the status of each client. This will ensure that retail clients are not incorrectly categorised as professional clients (which might result in them being included in an unsuitable target market) and will also ensure that they benefit from the additional protection of the appropriateness test (discussed below).
19. The assessment should also consider whether conflicts of interest arise in the sale of complex products especially when the selling entity is the issuer or is acting as the counterparty of the transaction. The compliance function should consider if incentives relating to the product create conflicts of interest, and should specifically assess whether incentives (i.e. inducements or remuneration<sup>7</sup>) are more lucrative for complex products than for those of more standard investments. NCAs should monitor that firms make sure that any such conflicts are identified and managed.

#### Suitability

20. In their supervisory practices, NCAs should monitor that before a firm decides to advise clients on complex products, it first applies a high level of due diligence to evaluate those products. This evaluation should assess the intelligibility of the risk-reward profile, the level of leverage, and all the various risk components of the product (including market risk, credit/counterparty risk and liquidity risk).
21. In July 2012, ESMA published ‘Guidelines on certain aspects of the suitability requirements’<sup>8</sup>. In respect of “complex or risky” products, those guidelines clearly state that “investment firms should carefully consider whether they need to collect more in-depth information about the client than they would collect when less complex or risky instruments are at stake. This is so firms can assess the client’s capacity to understand, and financially bear, the risks associated with such instruments.”
22. NCAs should monitor that the “more in-depth information” for complex products required by firms enables firms to consider the implications the investment will have for the client. For example, firms should assess and establish:
  - (i) The client’s investment objectives and attitude to risk, especially for investments involving leverage, and those linked to highly volatile asset classes.
  - (ii) The client’s time horizon for the investment, especially in light of the possible lack of liquidity of the product (for products with fixed terms, firms should determine whether the retail client will require access to any of the complex product’s funds during the term of the investment).

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<sup>7</sup> See “Guidelines on remuneration policies and practices (MiFID)” [ESMA/2013/606], and CESR “Inducements under MiFID – Recommendations May 2007” [CESR/07-228b and Inducements: report on good and poor practices (CESR/10-295)]

<sup>8</sup> <http://www.esma.europa.eu/system/files/2012-387.pdf>

- (iii) Whether the client will have sufficient funds remaining to cover reasonably foreseeable future commitments and to comfortably afford any potential investment losses. This is particularly relevant when:
  - i. considering the amount of capital loss a client is exposed to, since complex products can offer varying degrees of capital protection;
  - ii. the investment places the client's capital at risk or exposes the client to losses that potentially exceed the initial amount of the investment.
- (iv) The charges and costs involved in the product. In particular, whether:
  - i. the client is fully aware of, and understands, the impact of the risks and costs related to any investment they recommend;
  - ii. the client is informed that the additional complexity of a product usually has a cost, and that this cost will impact the return. The possibility of whether an alternative, less complex investment and with lower costs would better meet the client's financial needs and investment objectives should also be assessed.
- (v) The retail client's knowledge and experience in order to assess whether the client understands the risks involved in the transaction. In this regard, firms should consider whether the retail client has experience from past transactions regarding the same or similar complex product that is being recommended. Article 37 of the MiFID Implementing Directive sets out a non-exhaustive list of information that that firm will need to ask the client to evaluate his knowledge and experience. MiFID provides that the precise components and rigour of information gathering and assessment will vary according to the nature of the client, the nature and extent of the service to be provided, and the type of product or transaction envisaged, including their complexity and the risks involved. NCAs should monitor that when assessing a client's investment objectives, financial situation, knowledge and experience, firms do not rely unduly on a client's self-assessment, and that firms have in place adequate policies and procedures to ensure that the clients' information is correct and up-to-date.

#### Appropriateness

- 23. In their supervisory practices, NCAs should monitor that, when assessing appropriateness, firms consider all elements and features that determine the complexity of the product and the risks involved and should assess the knowledge and experience of the client in that context. Paragraph 22(v) above is equally relevant to the assessment of appropriateness, as the criteria set out in Article 37 of the MiFID Implementing Directive apply to both suitability and appropriateness.
- 24. NCAs should monitor that firms that choose to have standardised processes in place to assess appropriateness do not simply use this process as a self-certifying exercise. For example, a long and complicated risk warning, followed by a single 'tick box' that a client has understood the risks of a product, is unlikely to indicate clearly that the client has sufficient knowledge and experience.
- 25. MiFID requires that if a firm considers, on the basis of the information provided by its client, that the product is not appropriate, it must warn the client. MiFID also specifies that where a client does not provide (sufficient) information on his/her knowledge and experience, the firm should warn the



client that such a decision will not allow the firm to determine whether the service or product envisaged is appropriate for him/her.

26. NCAs should monitor that, where in the above circumstance firms still give access to complex products, the above mentioned warnings should clearly specify that the client is not likely to understand the risks involved in relation to these complex products. ESMA believes that NCAs should carefully monitor internal controls and processes of firms that have a consistently high number of clients that refuse to provide information for the appropriateness assessment.
27. ESMA notes that the sale of some complex products (i.e. those other than complex financial instruments under MiFID) on a non-advised basis does not require the performance of the appropriateness test (execution-only services) if the other conditions set out in MiFID Article 19(6) are met.<sup>9</sup>

#### Disclosure (including marketing communications)

28. For complex products, the information used to advertise or disseminate such products can often be aggressive or misleading. Therefore, when communicating the key features and risks of complex products, particular attention should be given to ensuring that that communication is fair, clear and not misleading. In particular, information relating to complex products should include disclosure of the following:
  - (i) Total amount of costs and charges applicable for the product. NCAs should encourage firms (a) to disclose cash values, even if based on example amounts, to aid client understanding, and (b) to also include an indication of the relative impact of charges on future investment performance. In carrying out their supervisory duties, NCAs should monitor that firms also disclose the various components of the financial outlay incurred by the client. The client could also be provided with an indication of the disinvestment value immediately after the transaction, assuming that market conditions remain unchanged.
  - (ii) Potential consequences of seeking to sell or exit early for the client (if there is no liquid secondary market easily available or if there are exit charges). NCAs should monitor that firms explain how long the client may need to hold the investment. Where there are exit charges, the firm should explain that if the client withdraws early from the investment, the client may receive less than what was originally invested because of the impact of these charges. Conversely, if a product allows access to the funds invested before the maturity of the investment, this should be clearly indicated alongside a summary of what effect this will have on the performance of the investment.
29. ESMA considers that NCAs should monitor that firms also consider the following when applying the “fair, clear and not misleading” principle:
  - (i) Explaining the potential benefits and returns in the simplest way possible. For example,
    - i. the prospect of achieving a maximum ‘headline’ return should be realistic, clearly explained and not be the main feature of the communication;

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<sup>9</sup> For example, subordinated bonds and CFDs are considered as complex products for the purposes of this opinion. However, the non-advised sale of some subordinated bonds would not, if the other conditions set out in MiFID Article 19(6) are met, require the appropriateness test, while the non-advised sale of a CFD would require the appropriateness test.

- ii. '110% return' can be misleading where this return is only achieved after a number of years – so, it would be clearer to also state the annual equivalent rate of return for each year of the investment.
  - (ii) Avoiding jargon, and explaining technical terms in a straightforward manner. NCAs should monitor that firms specifically avoid ambiguous terms such as “absolute” or “hedged”.
  - (iii) The application (or not) of any national investor compensation scheme to a product in the case of the provider defaulting should be clearly and accurately disclosed and described, and this should ensure clients are aware this does not cover poor investment returns.
30. Furthermore, where relevant to a particular complex product offering:
- (i) The scope and nature of any guarantee or capital protection offered should be clearly explained. In particular, NCAs carrying out their supervisory duties should monitor that firms:
    - i. indicate which feature of the product is ‘guaranteed’ or ‘protected’;
    - ii. clearly explain whether the guarantee or capital protection is of a full or partial nature;
    - iii. set out who is providing the guarantee/security and whether it is contingent on any return or counterparty performance; and
    - iv. clearly explain what would happen in the event of default by any party connected to the guarantee.
  - (ii) NCAs should monitor that firms explain the impact of any leveraging and/or embedded derivatives in the complex product envisaged. NCAs should monitor that firms make sure equal prominence is given to the risks as well as the benefits of such features. For example, for leveraged products, firms should indicate the risk of multiplying losses and not only focus on the potential for increased returns.
  - (iii) Where a ‘wrapper’ is used to include underlying instrument(s), NCAs should monitor that firms explain how the legal status of the product works and how investor compensation schemes apply (or differ if direct investment in the underlying instruments took place). NCAs should also monitor that firms explain if the investment strategy of the wrapped product must comply with relevant regulation – for example, with UCITS.
  - (iv) The non-advised sale of complex products should always be accompanied by a clear and specific warning on the main risk characteristics of the product (Article 31 of the MiFID Implementing Directive). This should also be presented in a fair, clear and not misleading manner, and be comprehensible to the audience for whom it is intended.

#### On-going monitoring (compliance risk assessment)

31. In performing their supervisory duties, NCAs should monitor that firms’ compliance functions take a risk-based approach to determining the focus of the monitoring and advisory activities of the sales function. The more complex the product, the more scrutiny the firm’s compliance function should



apply. In particular, therefore, NCAs should monitor that the sale of complex products is identified as an area of the firm's investment services that requires close scrutiny.

32. ESMA considers that this assessment should include the consideration of issues identified in complaints received. In this context, it is important that NCAs monitor that all firms have a robust complaints procedure to ensure all relevant complaints are captured and underlying issues identified.
33. This compliance risk assessment should be performed regularly and be well documented to ensure that the focus and the scope of such monitoring remains valid.

#### Execution of client orders

34. MiFID requires firms to establish an order execution policy to allow them to obtain the best possible results for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. In addition to these factors, firms must, amongst other things, also consider the characteristics of the financial instruments and the execution venues.
35. ESMA considers that the choice of execution venues (including where the firm is acting as a market maker) for both the purchase and sale of complex products should be carefully reviewed and sufficiently flexible to ensure that the firm can deliver the best possible results for its clients.
36. When carrying out their supervisory duties, NCAs should monitor that firms make sure that the sale of any complex products meets the firm's best execution obligations.