



ESMA opinion on MiFID practices on firms selling complex products. March 2014.

ESMA has published, the 7th of February, **an opinion on the sale of complex products by investment firms to retail investors**. ESMA's competence to deliver opinions to competent authorities is based on article 29.1.a) of the Regulation No 1095/2010 (the ESMA Regulation). ESMA has issued, on the same date, a warning to investors about the risks of investing in complex products.

Due to low returns from more traditional forms of investments or ordinary deposits and market volatility, investment firms have responded offering complex investment products (including structured products) to retail clients that allow them access to asset classes, market segments and investment strategies that were previously only available to professional clients. This trend poses certain risks for retail investors: they may not be able to understand the risks, costs, and expected benefits of the product hampering their ability to make informed investment decisions.

The ESMA Committee on Economic and Market Analysis (CEMA) published last summer an economic report on the sale of complex financial products to retail investors in the European Union. The report divided the retailisation market in two parts: 1) UCITS pursuing alternative investment strategies (alternative UCITS), and 2) structured products targeted to retail investors. (See previous editions of the International Bulletin).

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 Directive 2004/39 and 38 of the MiFID implementing Directive 2006/73. Complexity is a relative term, many elements can make a product difficult to understand. Products are likely to be considered complex if:

- they are derivatives, or embed a derivative.
- they are made up of one or more underlying financial instruments that are difficult to value, or are combined in such a way so as to make it difficult to assess the risk involved and the likely performance scenarios.
- they use more opaque indices that are form example set up by the product manufacturer, rather than using standard market indices.
- they have a fixed investment term with barrier to exit, for example, penalties in case of early exit that are not clearly explained.
- they have returns/pay off structures involving multiple variables or complex mathematical formulas.
- they include capital protection that may be conditional or partial, or that can be withdrawn on the occurrence of certain events.

The following specific products are examples of products that should be considered as complex: as-set-backed

securities; types of bonds such as convertible or subordinated; certificates; contracts for difference (CFDs); credit linked notes; structured products; and warrants.

ESMA is issuing this opinion to remind competent authorities, without prejudice to any legislative initiatives being undertaken, about the **relevant MiFID provisions governing selling practices (conduct of business rules)** and about the firms' necessary application of these provisions to the sale of complex products taking into account the growing complexity of financial products and the increasing use of internet.

Organization and internal control

Competent authorities should monitor that: i) firms have in place adequate internal controls for investment services in complex products in order to avoid detrimental practices towards clients; ii) firms do not offer advice on a complex product or sell it when, following firms' due diligence, it appears that will never meet the best interests of the clients or there is a lack of sufficient information available to ascertain its risks; iii) those responsible of the establishment of the target market fully understand the nature and workings of the complex product, which is particularly relevant in the case of new products; iv) the staff have sufficient knowledge of the relevant regulatory requirements to assess the needs and circumstances of the clients; v) firms, when selling complex products on a non-advised basis, offer them only to professional clients (according to the appropriateness test) and their categorisation is regularly monitored; and v) conflicts of interest (due to incentives that made it more lucrative) do not arise in the sale of complex products.

Suitability

Competent authorities 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 assessing the intelligibility of the risk-reward profile, the level of leverage, risks (liquidity, leverage, market, credit) and costs. ESMA guidelines on certain aspects of the MiFID suitability requirements (2012) indicated that, when providing access to complex financial instruments, investment firms should carefully consider whether they need to collect more in-depth information about the client than they would collect when less complex 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. The more in-depth information refers to: investment objectives and attitude towards risk, client's time horizon for the investment, whether the client will have sufficient funds remaining to cover reasonably foreseeable future commitments and potential investment losses, the charges and costs involved in the product, and the retail client's knowledge and experience in order to assess whether the client understands the risks involved in the transaction and, in particular, whether the retail client has experience from past transactions regarding the same or similar complex products. Competent authorities should monitor that firms do not rely unduly on a client's self-assessment on knowledge and experience.

Appropriateness test

Competent authorities should monitor, when assessing appropriateness tests, that : i) firms consider all elements and features that determine the complexity of the product and the risks involved and assess the knowledge and experience of the client in that context; ii) firms that choose to have standardised processes in place to assess appropriateness (for example, a long and complicated risk warning followed by a single " tick box") its use is unlikely to indicate clearly that the client has sufficient knowledge and experience; and iii) if a firm considers that the product is not appropriate or that the client does not provide sufficient information on his/her knowledge and experience, the firm should warn the client.

Disclosure (including marketing communications)

Marketing communications of the key features and major risks of complex products must be fair, clear and not misleading. Competent authorities should monitor that information relating to complex products should include

disclosure of the following: i) includes the total amount of costs and charges applicable to the product; ii) includes potential consequences of seeking to seek or exit early for the client (if there is no liquid secondary market easily available or if there are exit charges); iii) includes an explanation objective of the potential benefits and returns in the simplest way possible; iv) avoid using technical terms and ambiguous terms such as "absolute" or "cover"; v) include the applicability (or not) or any national investor compensation scheme; vi) explain the scope and nature of any guarantee or capital protection offered; vii) explain the impact of any leveraging and/or embedded derivatives in the complex product envisaged; and viii) should be accompanied, in case of non-advised sale of complex products, by a clear and specific warning on the risks of the product.

On-going supervision (Compliance risk assessment)

Competent authorities should regularly monitor that the firms' compliance functions take a risk-based approach related to the sale of complex products. ESMA considers that this assessment should include the consideration of issued identified in complaints received.

Execution of client orders

Competent authorities should monitor the investment firms perform the sales of complex products in compliance with the obligation of client's best possible result (best execution). To do this, investment firms must comply with the order execution policy set to obtain the best possible results for their clients, and choose of execution venues that ensure the firms can deliver the best possible results for its clients.

If you want to read ESMA opinion on MiFID practices form firms selling complex financial products, please, click on: http://www.esma.europa.eu/system/files/ipisc_complex_products_-_opinion_20140105.pdf

If you want to read ESMA investors warning of the risks of investing in complex products, please click on: http://www.esma.europa.eu/system/files/ipisc_complex_products_-_opinion_20140105.pdf