

CESR Public Consultation

(ref: CESR/09-295)

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

1. *Association française des marchés financiers* (AMAFI) has more than 120 members representing over 10,000 professionals who operate in the cash and derivatives markets for equities, fixed-income products and commodities. Nearly one-third of the members are subsidiaries or branches of non-French institutions. AMAFI welcomes the opportunity to comment on the Consultation Paper (CP) issued by CESR on MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements.

2. Before answering the specific questions raised by CESR in its CP, AMAFI would like to make the following observations: when MiFID came into force in the various European countries, the investment firms and banks who wanted to offer the "execution-only" service to their clients had to make a number of decisions regarding the instruments to be considered as non-complex or complex and those to be assessed against the tests of Art. 38 of MiFID Level 2. One might regret that the proposed clarification was not available at that time where the investments firms had to incur significant costs to adjust their systems for that purpose...

3. Having said that, AMAFI fully support every effort that the authorities, and CESR in this particular case, are making to clarify the application of European legislation as such clarification can only help increase legal certainty and promote greater convergence in interpretation, thus contributing to a level-playing field. The distinction between complex and non-complex instruments is certainly an area in which different interpretations are possible on certain issues and consequently, the proposed clarification, even if it comes a bit late, is welcome on the basis that it does not propose to deviate from the principles set out in the MiFID Level 1 and 2.¹

4. This does not mean, however, that some of these principles should not be reviewed in the context of the upcoming review of MiFID. While this consultation deals only with interpretation issues, the need for adjustments/modifications on certain issues at legislative level should also be kept in mind by the authorities for discussion in due course.

¹ Any such deviation could in any case be disputed before the Courts.

SPECIFIC QUESTIONS RAISED BY CESR

➤ SECTION 1 – SHARES

⇒ **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**

5. CESR’s view is that the reference to “*shares*” in Art. 19(6) of MiFID Level 1 - which are to be considered as automatically non-complex - should only cover shares in companies (when they are admitted to trading) and exclude other type of equity securities negotiable in the capital markets.

6. AMAFI disagrees with that view. While it is true that MiFID does not define the specific term “*shares*”, it is also true that when it defines, in Art. 4(1)(18) of MiFID Level 1, the different types of securities which are covered by the term “*Transferable securities*”, it assimilates in the first category the “*shares in companies*” and the “*other securities equivalent to shares in companies, partnerships or other entities and depositary receipts in respect of shares*”, as duly noted by CESR.

7. Therefore, it would have been useful to understand why CESR favours a restrictive view of the term “*shares*”. AMAFI considers that such restrictive view is not justified when it comes to instruments such as “*investment certificates*” which are similar to shares with the exception that the voting rights, normally attached to such instruments, have been allocated to a separate holder of a “*voting rights certificate*”. These instruments are by nature as “non-complex” as, if not even more “non complex” than, shares.

8. Likewise, AMAFI considers that depositary receipts in respect of shares are no more complex than the shares that they represent and should therefore also be assimilated to shares for that purpose and considered as automatically non-complex.

9. Finally, AMAFI considers also that subscription rights should also be included in the same category as “*shares*” but will revert to this issue in relation to Question 6 below.

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

10. While there is no doubt that shares in a UCITS are to be considered as automatically non-complex, AMAFI agrees that shares in a non UCITS should be assessed against the criteria set out in Art. 38 of MiFID Level 2 and treated as non-complex only if they meet those criteria.

11. As regards preference shares - which under French law are treated as equity and not as a debt instrument - AMAFI’s view is that they should be treated as automatically non-complex because they are shares unless they embed a derivative, in which case they should be treated as complex. AMAFI, which clearly is not aware of all legislations existing within the European Union, does not wish to question the fact in certain legislations, this may be the case (i.e. a share may embed a derivative). However, AMAFI would like to ensure that in considering that a preference share may embed a derivative, CESR does not make the same confusion as that which AMAFI respectfully believes is being made with respect

to convertible shares, as explained more in detail below (*please refer to § 16*). Consequently, AMAFI believes that it is only if the mechanism of a given preference share embeds a financial contract which falls under the category of a derivative that such preference share should be considered as complex. Otherwise, it believes that preference shares should be treated as non-complex instruments.

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

12. AMAFI does not have any other comment in relation to this matter.

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

13. AMAFI agrees in principle with CESR's approach, save with respect to depositary receipts, as mentioned in § 8 above. As CESR points out, a depositary receipt is a transferable security which represents another security (generally equity or debt). If the security represented by the depositary receipt is non-complex by nature, there is no reason why the security which merely represents such non-complex instrument should not be considered itself as non-complex.

14. AMAFI would also like to make a specific comment regarding the statement - which it approves - that shares that are not traded on a regulated market are to be assessed against the criteria of Art. 38 of MiFID Level 2. In the vast category of MTFs created by MiFID, there exists a variety of financial markets, some of which are subject to constraining rules which make them *de facto* very close to regulated markets. AMAFI believes therefore that in the context of the upcoming review of MiFID, it might be fair and reasonable to consider the possibility of extending to those "very regulated" MTFs the benefit of Art. 19.6 of MiFID Level 1 and therefore consider that shares traded on those markets could be treated as automatically non-complex.

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

15. AMAFI disagrees with CESR's view that convertible shares should automatically be considered as complex instruments. CESR's reasoning is based on the fact that the « option » that the holder of such convertible shares has to convert, or not convert, its shares into a different type of shares, makes such instrument fall automatically into the category of derivatives which should indeed be considered as complex.

16. AMAFI believes that such reasoning is based on a confusion regarding the meaning of the word "option". The different types of "options" mentioned paragraph (4) to (10) of Section C of Annex 1 to MiFID Level 1 are by nature financial contracts which are commonly referred to as "derivative contracts" and indeed are complex instruments by nature.

Convertible shares, on the other hand, are shares, i.e. equity instruments, which include a peculiarity in the sense that they include the possibility (or "option" with the ordinary - not legal - meaning assigned to that word) for the holder of that equity instrument to convert or not convert it into another type of shares. The simple fact that the holder of a share may convert it into a different type of share does not make such instrument fall in the category of derivatives.

Therefore, AMAFI strongly supports the view that convertible shares should not be considered as being automatically and always complex. Such instruments, like other shares traded on a regulated market, should, in AMAFI's view, be considered as non-complex by nature or at least be assessed against the criteria of Art. 38 of MiFID Level 2, it being specified that they should meet the test of paragraph a) of such article since, as indicated above, they are not to be considered as "derivatives" and therefore do not fall within the category of the instruments mentioned in such paragraph a).

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

17. AMAFI does not agree with CESR's view that subscription rights should be treated as complex instruments because they supposedly fall within the type of transferable securities described in Art. 4(1) (18)(c). It notes with great interest that CESR recognizes that this interpretation could be challenged because it is "*possible to analyse the rights not as a separated security but as a component of the share itself that is separated from the share only to facilitate the taking up and the trading of the rights*" with the consequence 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*".

18. AMAFI fully approves this alternative view with the logical and necessary conclusion drawn by CESR itself (even if CESR in the end does follow that interpretation) that subscription rights/nil-paid rights which exist automatically and mechanically as a result of the issuance of shares should be treated in the same way as the shares i.e. as non-complex instruments.

19. Another argument to support the view that these rights should be treated as the shares themselves is, again, raised by CESR itself when it recognizes that treating such rights as complex may be problematic in practice given the usually very short time frame within which it is necessary to make an investment decision regarding the rights. CESR notes therefore that "*it may not be in the interest of the shareholder 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*". It could also be added that it would be somewhat illogical to subject the sale of the rights to the appropriateness test as a consequence of being considered as a complex instrument whereas when the shareholder acquired the shares (at the time of the original issuance or by way of subsequent acquisition) to which such rights were attached, it was not subject to such test and will not be subject to such test either in the event of subsequent sale of such shares.

20. For all these reasons, AMAFI strongly supports the view that subscription rights/nil-paid rights should be treated both for legal and practical reasons as the shares themselves, i.e. as non-complex instruments. If CESR were not prepared to accept such position, AMAFI considers that the rights in question should at least be given the opportunity to be assessed against the criteria of Art. 38 of MiFID Level 2, it being specified (*as in § 16* above regarding convertible shares) that it should be made clear in that case that they should meet the test of paragraph a) of such article since, as indicated above, they are not to be considered as "derivatives" and therefore do not fall within the category of the instruments mentioned in such paragraph a).

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

21. AMAFI does not have any further comment in this connection.

⇒ **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?**

22. AMAFI does not have any further suggestion to make in this connection.

➤ **SECTION 2 – MONEY MARKET INSTRUMENTS, BONDS AND OTHER FORMS OF SECURITISED DEBT**

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

23. AMAFI agrees with CESR's view that money market instruments should be treated automatically as non-complex instruments except if and when they can be regarded as embedding a derivative instrument, in which case, they should be regarded as complex. Following its comment above in § 11 and 16, AMAFI would just like to ensure that the money market instruments which would be treated as complex would really be those embedding a financial contract which would fall in the category of "derivatives".

⇒ **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?**

24. AMAFI does not have any further comment in this connection.

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

25. CESR's view is that certain types of securitised debt structures - and in particular Asset Backed Securities (ABS) - cannot be accurately described as non-complex. The logic behind that view is the same as for derivatives which are considered to be complex because their value is derived from another financial instrument. In the same way, the value of ABS is derived from the assets that underlie them and therefore should also be considered as complex.

26. AMAFI agrees that it is more difficult for a retail client to understand the risks involved in relation to a "structured product" such as an ABS or other forms of "securitised debt" and therefore it may be fair to consider such products as being complex. AMAFI wonders however if it is really fair to consider all "structured products" as being automatically complex as in practice, there are different degrees in the complexity of the "structured products" and some of them are in fact quite easy to understand. CESR itself considers that "*complexity for the purposes of the Directive is determined by the way that an instrument is structured*"². Therefore, instead of considering all forms of "securitised debt" as being automatically complex, shouldn't it be more appropriate to assess such products against the criteria of Art. 38 of MiFID Level 2?

² See CP § 7.

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

27. AMAFI considers that this is definitely a point on which MiFID could usefully be clarified. Indeed, CESR's proposal in relation to the treatment of ABS could be considered as not being in line with the terms of MiFID Level 1 itself as Art. 19.6 thereof specifically mentions "*bonds and other forms of securitised debt*" as being "non-complex" instruments by nature, the only exception being if "*those bonds or securitised debt that embed a derivative*". CESR's view, as expressed above in § 25, is therefore based on an interpretation of this Article, which even if is not unreasonable, may lead to some confusion as it appears to be in contradiction with the terms of the Directive itself. Beyond those "*forms of securitised debt*" the situation of all "structured" products could be usefully addressed, keeping in mind as mentioned above (*see § 26*), not all such products should be considered as being necessarily and automatically complex.

28. AMAFI suggests therefore that this issue (like the one raised in § 14 above) be reviewed also in the context of the upcoming review of MiFID.

⇒ **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)?**

29. AMAFI has no further comment in this connection.

⇒ **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?**

30. AMAFI has no further comment in this connection.

⇒ **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)?**

31. AMAFI agrees that instruments that embed a derivative should be considered as complex under Art. 19.6 of MiFID Level 1. It disagrees however with the inclusion, in the list of such instruments which appears in § 54 of the CP, of convertible and exchangeable bonds for the reason expressed above (*in § 16*) in relation to convertible shares. Convertible bonds are debt instruments which include the possibility (or "option" in the ordinary – not legal – sense of the word) for the holder of such instrument to convert it into, or exchange it against, shares which are themselves by nature non-complex instruments. This "option" does not change the nature of these instruments and does not give them the nature of a "derivative".

AMAFI therefore strongly disagrees with CESR's view that convertible bonds (and exchangeable bonds) can be regarded as "*bonds embedding a derivative and thus ineligible to be regarded as non-complex instruments*". On the contrary, AMAFI believes that such instruments should be regarded as non-complex instruments by nature or at least they should be assessed against the criteria of Art. 38 of MiFID Level 2, it being specified that they should meet the test of paragraph a) of such article since, as indicated above, they are not to be considered as "derivatives" and therefore do not fall within the category of the instruments mentioned in such paragraph a).

⇒ **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?**

32. The exact same reasoning applies to "callable" and "puttable" bonds. The call or put "option" in that case is merely either the right for the issuer of the bond to redeem the bond prior to the maturity date under certain conditions (callable bond) or the right for the holder of the bond to ask the issuer to repurchase the bond before its maturity under certain conditions (puttable bond). There is no complexity involved in such mechanism and the fact that the issuer may choose, or be forced, to redeem the bond before its maturity date under certain pre-determined conditions does not change the nature of such instruments.

33. AMAFI therefore strongly disagrees with CESR's view that "callable" and "puttable" can be regarded as "*bonds embedding a derivative*" and therefore could not be regarded as non-complex. On the contrary, AMAFI believes that such instruments should be regarded as non-complex instruments by nature or at least they should be assessed against the criteria of Art. 38 of MiFID Level 2, it being specified that they should meet the test of paragraph a) of such article since, as indicated above, they are not to be considered as "derivatives" and therefore do not fall within the category of the instruments mentioned in such paragraph a).

⇒ **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.**

34. AMAFI agrees in principle with CESR's distinction between « *traditional covered bonds* » which are to be considered as non-complex instruments and "*structured covered bonds*" which are similar to ABS and should be treated in the same fashion. In this connection, it would just like to reiterate its comment above (*in § 26*) regarding structured products.

35. AMAFI appreciates that subordinated bonds contain an additional element of risk for the investor and that, on that basis, it could be fair to exclude such instrument from the scope of the execution-only service. However, CESR states³ that « *the complexity of a financial instrument per se is not necessarily synonymous with the risk associated with that instrument* ». Consequently, if indeed the relevant criterion is the complexity and not the risk attached to a given instrument⁴, one can question the categorisation of subordinated bonds as complex instruments. Even more so as CESR's reasoning is based on an analogy with the « *other types of bonds and securitised debt* » which, as already mentioned, should, according strictly to the terms of Art. 19.6 of MiFID Level 1 should be considered as "non complex" by nature (*see comment in § 27 above*).

36. Likewise, and as for depositary receipts in respect of shares⁵, AMAFI considers that "*depositary receipts in respect of such securities*" (such securities being "*bonds and other forms of securitised debt*") which are specifically mentioned in article 4(18) (b) of MiFID Level 1 should be treated as the instruments that they represent. Please refer to § 27 above and the need to clarify this matter.

³ See CP § 7

⁴ See however comment in § 56 below

⁵ See § 8 above

⇒ **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?**

37. All of the above indicates that there is clear need to review MiFID's treatment of debt and these questions should be raised in the context of the upcoming review of MiFID.

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

38. AMAFI has no further comment in this connection.

⇒ **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?**

39. AMAFI has no further comment in this connection.

➤ **SECTION 3 – UCITS AND OTHER COLLECTIVE INVESTMENT UNDERTAKINGS**

⇒ **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?**

40. AMAFI supports CESR's view mentioned above. The fact that a non-UCITS invests in derivatives or in other types of complex instruments does not automatically make units or shares in the undertaking itself complex. The categorisation of an investment in such an undertaking as a non-complex or a complex instrument should rather, indeed, depend on the fulfilment or not of the criteria set out in Art. 38 of MiFID Level 2.

⇒ **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?**

41. AMAFI agrees that *ETFs*, capital protected funds and hedge funds which are structured as UCITS will automatically be non-complex. It seems fair to assess other units in collective investment undertakings against the criteria of Art. 38 of MiFID Level 2. Incidentally, AMAFI is a bit surprised by CESR's comment in § 83 of the CP regarding the fact that liquidity is not part of the qualitative criteria of MiFID Level 2 as the criteria set in subparagraph b) of Art. 38 c deals precisely with the liquidity of the instrument⁶.

⁶ "b) there are frequent opportunities to dispose of, redeem, or otherwise realise that instruments at prices that are publicly available to market participants..."

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

42. AMAFI has no further comment in this connection.

⇒ **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?**

43. AMAFI has no further comment in this connection.

➤ **SECTION 4 – 'OTHER NON-COMPLEX FINANCIAL INSTRUMENTS' UNDER ARTICLE 38 OF THE LEVEL 2 DIRECTIVE: ISSUES OF GENERAL INTERPRETATION**

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

44. AMAFI agrees with CESR's view on the purpose of Art. 38 of MiFID Level 2. Given the variety of financial instruments and their constant evolution, it would not be appropriate indeed to draw a list of non-complex instruments. Defining the criteria to guide the scope of the non-complex instruments which are not mentioned in Art. 19.6 of MiFID Level 1 seems fully appropriate in the circumstances.

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

45. AMAFI agrees with CESR that the notion of "*frequent opportunities to dispose of, redeem, or otherwise realise that instrument*" should be considered on a case-by-case basis, taking into account the information available, the particular instrument in question and the standard practice in the markets for 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?**

46. AMAFI agrees with CESR that prices can be deemed to be publicly available when they meet the MiFID pre-trade et post-trade transparency requirements. In practice, they are indeed either market prices or prices made available, or validated, by valuation systems which are independent from the issuer.

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

47. AMAFI also agrees that the lack of liquidity could undermine the compliance with Art. 38 (b). The fact that an instrument (other than shares) is traded on a regulated market does not indeed ensure automatically that the criterion of "liquidity" will always be met.

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

48. AMAFI agrees that the existence of an « *actual or potential liability that exceeds the cost of acquiring the instrument* » 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. There does not appear to be a need for further clarification on this point.

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

49. AMAFI agrees with CESR's view of what constitute comprehensive and publicly available information.

➤ **SECTION 5 – OTHER PRODUCTS**

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

50. AMAFI agrees that deposits, loans, mortgages or life insurance products are not MiFID products and therefore are not concerned by the complex/non-complex categorisation.

51. Regarding ETCs, the key question is that of the exact legal nature of such instruments. If indeed they can be characterised as “contracts for differences”, then there is no doubt that they do not satisfy the first condition of Art. 38 of MiFID Level 2 as they would fall in the category of derivatives mentioned in Annex 1, Section C, § 9 of MiFID Level 1.

AMAFI would like however to ensure that this analysis is accurate from a legal standpoint, particularly since CESR's statement that ETCs “*are (in part) contracts for differences*” creates a doubt in its mind as to the legal nature of such instruments (on which AMAFI admits that it has no clear view at this point in time).

52. Naturally, if it could not be confirmed without doubt that ETCs have the legal nature of a derivative, then it would be appropriate to look at the way in which they are structured – notably by comparison with ETFs - and to assess those instruments against the criteria of Art. 38 of MiFID Level 2.

⇒ **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).**

53. AMAFI has no further comment in this connection.

➤ **SECTION 6 - CONCLUSION**

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

54. While AMAFI agrees with CESR that there should be no comprehensive and exhaustive list of how each type of financial instrument should be categorised, it is nevertheless useful to summarise the various positions expressed in the CP. Naturally, AMAFI disagrees with the proposed list on the few points on which it has expressed its disagreement with CESR's view.

55. Among those points (*see particularly § 6 to 9, 11; 13; 15 to 20, 31 to 33 and 36 above*), AMAFI would like to emphasize that the most crucial one concerns the classification of subscription rights/nil-paid rights (*see § 17 to 20 above*) which, in its view, should be treated as the shares themselves, i.e. as non-complex instruments. Beyond the legal and practical reasons already expressed that support such position, AMAFI wishes to stress that to the extent that those rights are inherent to the holding of the share itself and are therefore given automatically to the shareholder by the issuer, considering them as complex instruments would dramatically lower the benefits of providing the "execution only" service.

56. Beyond the list itself, it might also be useful to clarify the basis on which the distinction is made between non-complex and complex instruments as there is some uncertainty in the approach taken by MiFID and consequently by CESR in this respect⁷.



Contacts:

- Sylvie Dariosecq – Director of Legal Affairs, sdariosecq@amafi.fr + 331 50 83 00 70
- Emmanuel de Fournoux – Director of Market Infrastructures, edefournoux@amafi.fr +331 53 83 00 70

⁷ There seems in particular to be some contradiction in the CP between the statement appearing in § 7 (*"the complexity of a financial instrument per se is not necessarily synonymous with the risk associated with that instrument"*) and that appearing in § 112 (*"MiFID sought to take a risk-based approach in distinguishing between non-complex and complex instruments"*).