COMMENTS BY THE CNMV ADVISORY COMMITTEE ON THE CESR CONSULTATION PAPER ON MIFID COMPLEX AND NON-COMPLEX FINANCIAL INSTRUMENTS FOR THE PURPOSES OF THE DIRECTIVE'S APPROPRIATENESS TEST

The CNMV's Advisory Committee has been set by the Spanish Securities Market Law as the consultative body of the CNMV. This Committee is composed by market participants (members of secondary markets, issuers, retail investors, intermediaries, the collective investment industry, etc) and its opinions are independent from those of the CNMV.

On 14 May, the Committee of European Securities Regulators (CESR) released a consultation paper with regard to MiFID, specifically the classification of complex and non-complex products for the purposes of the appropriateness test (articles 19(5) and (6) of Directive 2004/39/EC).

The document presents CESR's preliminary point of view as regards the inclusion of MiFID products in the categories determined by EU legislation (complex and non-complex instruments).

The purpose of the consultation is to obtain the industry's opinion on CESR's preliminary comments with a view to establishing standard rules for the application of the requirements arising from the Level 1 and Level 2 Directives with regard to classifying products as complex or non-complex. The project also aims to increase legal certainty on these issues and promote greater convergence in interpretation of the regulation.

The CNMV Advisory Committee welcomes the content of the consultation, since it seeks to clarify which instruments will be considered complex and non-complex, thereby creating a level playing field in this area for all market participants.

However, the Committee is of the opinion that CESR should take account of the significant efforts that firms make to comply with MiFID. Any change with respect to commonly-accepted criteria could subject firms to additional costs; therefore, if doubts exist or in the absence of solid arguments for a given classification, the Committee prefers to respect the standard industry position, without prejudice to its review by national enforcers.

However, the Advisory Committee considers that the following clarifications, which apply to the document as a whole, are necessary.

Article 19(6) of the Level 1 Directive clearly states that the following instruments shall be considered non-complex: 1.- Shares that are admitted to trading on a regulated market or in an equivalent third country market; 2.- Money market

instruments; 3.- Bonds and other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative); 4.- UCITS and other non-complex financial instruments.

Article 38 of the Level 2 Directive states that financial instruments which are not included in the definitions contained in Article 19(6) of Directive 2004/39/EC but which fulfil the following conditions shall also be considered non-complex:

(i) those that do not fall within Article 4(1)(18) c) or points (4) to (10) of Section C of Annex 1 of Directive 2004/39/EC (options, derivatives and financial contracts by differences).
(ii) those in which there are frequent opportunities to dispose of, redeem, or otherwise realise the financial instrument at prices that are publicly available to market participants and that are either at market prices or prices made available, or validated, by valuation systems independent of the issuer;
(iii) those they do not involve any actual or potential liability for the client that exceeds the cost of acquiring the instrument;
(iv) those for which sufficient information about their characteristics is available to the public. This information must be readily comprehensible so as to enable the average retail client to make an informed judgement as to whether to enter into a transaction in that instrument.

The Advisory Committee is of the opinion that the instrument categories set by the legislator are quite generic, which allows for a range of different types of instruments to be covered. At all events, the Committee considers that if an instrument falls into any of the categories in article 19(6), it will not be necessary under any circumstances to verify compliance with the requisites under article 38 of the Level 2 Directive to provide an appropriate classification. The purpose of Article 38 is to define the "other non-complex financial instruments" referred to in Article 19(6), establishing criteria for this purpose.

If doubts exist as to the classification of a financial instrument in the categories established by the legislation, that instrument may always undergo the test provided in article 38 to determine if it fulfils the requirements to be considered non-complex.

Nevertheless, it's worth noting that MiFID offers retail clients extensive protection and information, including those cases in which the product is non-complex and the service is provided on an "execution-only" basis. In those cases, clients continue receiving all pre- and post-trade information. Therefore, the Committee wishes to make it clear that product classification is one part of the protection system contained in MiFID and that, in designing the regime, the regulator also established a system for protecting/informing clients which is less costly and is applicable in situations where the clients are not subject to the appropriateness test. Moreover, a suitability test is required in the area of portfolio management and investment recommendations, thereby providing investors with a high level of protection without prejudice to the specific classification of the product.

Following that preamble, below is the Advisory Committee's position with respect to the questions included in the Consultation:

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 (i.e. shares in companies when admitted to trading, which would be automatically non-complex) and exclude other types of equity securities negotiable in the capital markets?

The Committee is of the opinion that the term "shares" is generic and should cover all types of shares traded in existing regulated markets. If the legislators had wished to exclude a type of share, they would have done so clearly (as is the case with bonds and other types of securitised debt which have embedded derivatives and other types of securitised debt). The Committee believes that all shares traded on regulated markets should automatically be considered to be non-complex, regardless of their type. Therefore, article 19(6) should not be understood as excluding other types of securities representing the capital of companies.

As regards other equity securities or *"shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares", given the vagueness of these products and the possible variations, they should be assessed against the criteria in Article 38 of the Level 2 Directive in order to be considered "non-complex".*

Question 2: CESR considers that shares in collective investment undertaking (non-UCITS) should be assessed against the criteria in Art. 38 of the Level 2 Directive, in the same way as units in non-UCITS open-ended and closed-ended undertakings are. Furthermore, CESR thinks that embedded derivatives in preference shares make them complex instruments. Do you have any comments on the approach to different interpretations of the category of shares?

The Committee does not share CESR's approach to non-UCITS non-harmonised collective investment undertakings. As stated above, listed shares should always be classified automatically as provided by the legislator. The Committee sees no specific reason, other than the neutral regulatory treatment of all non-harmonised collective investment undertakings (non-UCITS), for treating them outside the category of "shares" as determined by the legislation.

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

The Committee has no further comments.

Question 4: Do you agree that other equity securities, i.e. shares that are not admitted to trading on the regulated markets, depositary receipts for shares, stapled securities that comprise different types of security, should be assessed as per the criteria set up in Art. 38 of the Level 2 Directive?

The Committee considers that the other equity securities identified by CESR should be assessed as per article 38. In any event, that list should be considered open so that other instruments may be included in the future.

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

In the opinion of the Committee, they should be classified as *"other securities equivalent to shares in companies"* under (Art. 4 (1)(18) a) of Directive 2004/39/EC) and, as established under Questions 1 and 4, may be assessed as per the criteria of Article 38 to be classified as "non-complex". Therefore, the classification of the instrument will depend on its complexity. Nevertheless, if the prospectus defines a security as non-complex, the supervisor may express an opinion on this issue during vetting and determine whether it should be classified differently in the retail placement phase.

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

No. The Committee considers that they are "other securities equivalent to shares in companies" which are separated from such securities solely to facilitate their sale or waiver. Consequently, and as provided in the Directive itself (Annex 1, section C of MiFID), they should not in any case be considered as financial instruments in themselves and, hence, are not subject to classification. Therefore, the rules corresponding to the financial instruments to which they are related should apply.

The Committee considers that ancillary rights must, in any event, adopt the classification of the instrument to which they are related.

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

The Committee has no further comments.

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?

The Committee considers that the list is sufficient.

Section 2 - Money market instruments, bonds and other forms of securitised debt

Question 9: In CESR's view treasury bills and government/public bonds are covered by the references to money market instruments and bonds from Art. 19 (6). A certificate of deposit would be covered by MiFID where it is a transferable security, negotiable on the capital market. Most commercial paper would be treated as non-complex, except in the case of asset-backed commercial paper or where there is an embedded derivative. Do you have any comments on CESR's view on the treatment of money market instruments?

No. The Committee considers this treatment to be appropriate.

Question 10: In relation to question 9, are there other specific types of such instruments that should be explicitly mentioned in a list for the purposes of CESR's exercise?

No. The Committee considers that the list is appropriate for the purposes of this exercise.

Question 11: CESR is of the view that asset backed securities should not be regarded as non-complex instruments. Do you have any comments on CESR's view on the treatment of Asset Backed Securities?

Firstly, the Committee considers that bonds and other asset-backed securities which do not embed a derivative fall perfectly within the category determined by the legislator ("other forms of securitised debt") in article 19(6) of the Level 1 Directive.

The structure of securitisation trusts contains a number of "credit enhancements" that determine the issue's credit rating. In our experience, the most frequent forms of credit enhancement in practically all securitisation trusts are IRS and currency swaps, which provide greater protection to the structure and, consequently, to the investor.

Therefore, the Committee considers it advisable to insist that, as provided in Article 19(6), asset-backed securities should only be classified as complex instruments if they directly embed a derivative.

Nevertheless, it should be noted that these products are not normally marketed to retail clients nowadays.

Question 12: In relation to question 11, do you think that this is a point on which MiFID could usefully be clarified?

No. The Committee considers that no clarification is required in this connection.

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)?

No.

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?

No.

Question 15: Financial instruments that could be assumed to embed a derivative include in CESR's view credit linked notes, structured instruments whose performance is linked to the performance of a bond index, structured instruments whose performance is linked to the performance of a basket of shares with or without active management, structured instruments with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares with or without active management, convertible bonds, exchangeable bonds, structured instruments whose performance is linked to the performance of another underlying such as a commodity or a commodity basket. 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)?

The Committee considers that structured deposits whose nominal is fully guaranteed are strictly banking products that do not fall under the scope of MiFID (see the replies to questions 118 and 203 in the FAQ about MiFID on the European Commission's web site).

In Spain, two different types of structures deposit are distinguished. Those whose nominal is guaranteed, which are considered to be pure banking products and are outside the scope of MiFID (they are not financial instruments), and those where reimbursement of the nominal is not guaranteed and which are regulated by CNMV Circular 3/2000 require a prospectus (they are atypical financial products) and do fall under MiFID (they are financial instruments).

Therefore, there seems to be a contradiction between the position of the Commission as set out on its website and the list provided by CESR in this section. Consequently, the Committee considers that the category "structured

instruments with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares with or without active management" should be removed from the list.

Question 16: Do you agree with CESR's view that it is reasonable to categorize callable and puttable bonds as complex financial instruments for the purposes of the appropriateness test?

No. The Committee considers that such bonds' specific peculiar features do not make them so complicated as to classify them as complex financial instruments. Moreover, entities are obliged to provide clients with sufficient information to enable them to understand the peculiar features of the instrument they are going to acquire. Consequently, the Committee considers that bonds of this type should be classified as non-complex.

Question 17: Do you agree with CESR's distinction between traditional covered bonds (regarded as non-complex instruments) and structured covered bonds (regarded as complex instruments)? Is there a need for further distinctions in this space? If so, please provide details in your answers

Firstly, the Committee disagrees entirely with Spanish *participaciones preferentes* being treated differently in the document. *Participaciones preferentes* issued by Spanish credit institutions conform to the terms of the Capital Requirements Directive (CRD), including the aspects related to early amortisation. That is to say, Spanish *participaciones preferentes* are perfectly comparable to preference shares issued by financial institutions anywhere in the European Union.

In conclusion, there is no evident reason why Spanish "participaciones preferentes" should receive different treatment to that provided under MiFID for preference shares issued by European credit institutions.

Moreover, it is surprising that item 60 of the document, in the chapter on bonds, discusses the issue of preference shares, which are of a different legal nature.

Secondly, as to the question of whether preference shares (including Spanish "participaciones preferentes") are complex or non-complex, the Committee considers that they should normally be classified as non-complex. The spirit of MiFID is that any instruments that do not fall under the categories determined by the legislator and fulfil the requirements of article 38 can be considered non-complex. Preference shares are a hybrid between shares and fixed-income securities (both of which are categories defined in article 19(6)), which, because of their structure, are similar to subordinated debt (a non-complex product) but are classified for accounting purposes as equity securities of the issuer.

In any event, given their accounting treatment, they could be defined as *"other securities equivalent to shares"* Art. 4 (1)(18) a) Directive 2004/39/EC) and,

therefore, be assessed as per the test in Article 38, which would classify them as non-complex. Moreover, the Prospectus Directive treats them as equivalent.

Nevertheless, if the prospectus defines a security as non-complex, the supervisor may express an opinion on this issue during vetting and determine whether it should be classified differently in the retail placement phase.

Additionally, in connection with structured bonds, the Committee considers that the categorisation and definition of "covered bonds" and "structured covered bonds" are correct. In our opinion, this refers to what in Spanish are called *cédulas hipotecarias* and *titulizaciones de cédulas*; therefore, the *cédulas hipotecarias* are a non-complex instrument whereas *titulizaciones de cédulas* are a complex instrument if the bond itself embeds a derivative.

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?

No. The Committee considers that debt instruments are addressed clearly in MiFID with regard to the appropriateness test.

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

No.

Question 20: Are there other specific types of such instruments that should be explicitly mentioned in a list for the purposes of CESR's exercise?

No.

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?

As stated in the Level 1 Directive, UCITS are clearly and indisputably non-complex products. As for non-UCITS, the Committee considers that precisely because there are many different types (REITs, hedge funds, funds of hedge funds, and other collective investment vehicles that do not fulfil the requirements of the Directive as regards eligible assets or diversification) and because they are not harmonized (rather, they are subject to regulations in individual member states which often differ considerably), it cannot be stated on a universal basis that they are either complex or non-complex. Instead, that analysis (i.e. the requirements of Article 38) must be applied to each category existing in each country.

Nevertheless, the Committee considers that:

- All financial collective investment institutions, whether passported or otherwise, should be considered as non-complex products.

- Real estate investment trusts, hedge funds and funds of hedge funds also fulfill all the requirements to be classified as non-complex products, although the degree to which they fulfil the requirement regarding frequent opportunities to dispose of, redeem, or otherwise realise that financial instrument is debatable to the extent that the Directive does not define the term "frequent".

- In any event, the assessment must be made for each type or category of collective investment institution, without considering the portfolio composition, for two reasons:

  - MiFID does not consider a look-through as one of the requirements for classifying a product as non-complex. In fact, MiFID assesses the complexity of a product based on the difficulties that an investor may have in understanding the risks being incurred, obtaining information about the investment, its price or the form of valuation, or because the investment may generate exposure for the investor which exceeds the price paid, or where the investor cannot exit in a reasonable time, but it does not consider whether the product in itself represents a more or less risky style of investment. For example, it considers listed shares to be non-complex in all cases, despite the high volatility that may arise, as has been observed with some tech stocks in recent years.

  - Classification on the basis of the underlying could lead to constant reclassification, sometimes on a daily basis, between the complex and non-complex categories depending on the specific portfolio composition.

Question 22: Exchange Traded Funds which are structured as UCITS will be automatically non-complex. If a capital protected fund is an authorized UCITS, it will be categorized as a non-complex instrument by definition; other types of capital protected funds will have to be assessed against the criteria in Art. 38 of the implementing Directive. Hedge funds are currently in the same position for these purposes, although a hedge fund is traditionally less likely to be a collective investment undertaking authorized under the UCITS Directive. However, since it is likely that in some cases such an undertaking will not itself be authorised or regulated and that it will not be permitted to market to the public without restrictions, it seems reasonable to consider that it may not readily satisfy the criteria in Art.38 of the Level 2 Directive where this is the determining factor. Do you agree with CESR's analysis of the treatment of units in collective investment undertakings for the purposes of the appropriateness requirements?

Yes.

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

No.

Question 24: Are there other specific types of such instruments that should explicitly be mentioned in a list for the purposes of CESR's exercise?

No.

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, i.e. to confine the scope of "other non-complex instruments" only to those products that are adequately transparent, liquid and capable of being readily understood by retail investors?

Yes.

Question 26: Do you agree with CESR's interpretation of what constitutes frequent opportunities, i.e. daily, weekly or longer regular frequent, for the client to dispose, redeem or otherwise realise that instrument?

Yes. The Committee considers that the interpretation is correct.

Question 27: Do you agree with CESR's point of view on how prices should be determined, i.e. market prices or price made available/or

validated by valuation systems independent of the issuer, and when it is considered that those prices are publicly available?

Yes.

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

The Committee considers that this might be the case but, as the document notes, this should be considered by the firm.

Question 29: The existence of an actual or potential liability 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. Do you agree with CESR's view? Do you think than any other clarification is required?

Yes and No, respectively.

Question 30: Information is publicly available when it is easily accessible through channels that are easy to find for the relevant clients. A firm will also need to consider whether the language in which the comprehensive information is available will affect its ability to be readily understood so as to enable the average retail client to make an informed judgment as to whether to enter into a transaction in that instrument. Do you agree with CESR's view on what constitutes comprehensive and publicly available information?

Yes.

Section 5 – Other products

Question 31: Exchange Traded Commodities are (in part) contracts for differences that need to be treated as complex instruments. Since different structures can exist, firms should consider the regulatory classification in each case for the purposes of the appropriateness test. Do you agree with CESR's analysis of the position of these instruments?

Yes.

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).

No. The issuer should test the product as per Article 38, and the national supervisor can express an opinion in this respect during the prospectus vetting phase.

General question:

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

No.