

CESR consultation on MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements

FIN-USE Response July 16 2009

General comment

The appropriateness test required by MiFID in certain cases aims to increase the protection of clients (particularly retail clients).

We are happy that CESR stresses the point that: *“the appropriateness test is only one element of the requirements in MiFID relating to investment firms' obligations to disclose and explain risks to their clients. For example, the Level 1 Directive includes a general requirement on firms to provide ‘appropriate information’, in a ‘comprehensible form’, about any MiFID financial instruments and proposed investment strategies’; including ‘appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies’, so that clients are ‘reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis’. The Level 1 Directive also includes⁵ a general obligation on an investment firm to —act honestly, fairly and professionally in accordance with the best interests of its clients when providing investment services.*

*Further detail on information to be provided to clients, including about the risks associated with financial instruments, is included in the Level 2 Directive (in particular, Articles 30-34).
5 Article 19(1) of the Level 1 Directive 6 Article 13(2) of the Level 1 Directive*

It is important that MiFID firms recognise such general obligations (to the extent relevant) in cases where the appropriateness test does not apply, particularly where the client is a retail client.”

But it is unfortunate that CESR does not also refer here to the MiFID's inducements (article 26 of the Level 2 Directive): MiFID also prevents conflicts of interests at the distribution level and requires the disclosure of commissions received from third parties by distributors.

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?

Yes, we agree.

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

“Shares” categorized as non complex for the purpose of the appropriateness test should be only ordinary shares (voting or nonvoting). Any collective investment or mutual fund should

be excluded from that category and should be assessed against the criteria in Art. 38 of the Level 2 Directive. Preference shares and preferred stock should be excluded as well, as their risk, compared to that of ordinary shares can be more difficult to assess for retail clients.

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

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

Yes

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

Yes

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

One problem about subscription rights is that their markets is usually in the hands of a few professional traders, can be very volatile, lasts for a very short period, and is not transparent at all for the retail investor. Also, broker fees can deter the retail investor to trade a small amount of rights. Therefore they bear a specific trading risk, in addition to the fact that they are not in the category of ordinary shares. So, we believe they should be complex under the appropriateness requirement, although we do realize the very short timeframe to perform the test. If the subscription rights markets were more transparent and their broker fees adapted to retail investors (which is sometimes the case, usually due to the issuer’s will), we could consider them as falling in the same category as ordinary shares.

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

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?

Yes, the French “ABSA” (shares with share warrants attached): this type of securities should be complex under the appropriateness requirement.

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

FIN-USE refers to its response to the earlier CESR consultation on the transparency of non equity markets.

FIN-USE does not agree that these money market instruments such as treasury bills, certificates of deposit and commercial paper (either straight or asset-backed) should be treated as non-complex instruments for the purpose of the appropriateness requirements.

It is not their intrinsic features that make them complex for appropriateness purposes, but the fact that they are traded on non transparent, unregulated markets with a very difficult access for the retail investor, and even more importantly because they failed dramatically in 2007 and 2008. The commercial paper markets were even close for a long time. These markets’ participants have shown to be unable to provide a minimum of liquidity in the last two years.

It would be a big mistake to let retail investors being exposed to these products without the test. FIN-USE believes these markets should become much more transparent and accessible before being deemed as non-complex products for the purpose of the appropriateness requirements.

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?

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

FIN-USE agrees with CESR's view.

FIN-USE refers again to its response to the earlier CESR consultation on the transparency of non equity markets.

We even question whether ordinary bonds and EMTNs should be considered as non complex, given that professional markets participants have been unable to maintain minimum liquidity throughout 2008, and the liquidity of the corporate bonds markets is still very poor in 2009. These bond markets are unregulated, not transparent at all (whether pre or post trade). Bank EMTNs are sold at the banks tellers to retail clients often at a much higher price than the market price without the client even being aware of it. Again, it is not the intrinsic features of bonds that make the appropriateness test necessary, it is the unregulated, non transparent and often dramatically illiquid nature of their markets.

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

FIN-USE believes MifID has entirely missed the efficiency and transparency of non equity markets, especially bonds.

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: 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)?

No

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?

Yes.

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

Fin-USE agrees with CESR's distinction. Although, we regret that the summary of the prospectus, as required by the EC Prospectus Directive is not friendly to the retail clients and is likely not to be clear enough on these kinds of risk enhancers. We refer to [FIN-USE's response to the EC consultation on the review of directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending directive 2001/34/EC \(prospectus directive\)](#).

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?

Yes. We believe like CESR that the risks associated with these instruments, and therefore the risks faced by retail clients considering a transaction without taking advice, are likely to warrant a more differentiated approach. And not only because of the development of "*both volumes and complexity*" of fixed income markets, but also, and even more importantly, because of the expanding exclusion of retail investors from these markets, its severe lack of pre and post trade transparency, and its not less severe liquidity issues, as stated earlier.

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

Yes, the MiFID appropriateness test is not enough. Retail investors need to be much more thoroughly informed and advised about the severe risks they face that are generated by the illiquidity and lack of transparency of these fixed income markets. Every issuer should also disclose clearly and precisely how and where the issue will be listed, how it intends to ensure a minimum liquidity level on the secondary markets if any, who are the market makers for the issue and what are their mandates if any. Also, the retail investor should be clearly informed at the time of subscription of the market price if any of the issue, or of the most comparable one.

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?

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?

Yes, but in that case, they must really meet the criteria set in Art. 38 of the Level 2 MiFID Directive, especially the fourth one: "*Adequately comprehensive information on its characteristics is publicly available and is likely 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.*"

Question 22: Do you agree with CESR's analysis of the treatment of units in collective investment undertakings for the purposes of the appropriateness

We agree with CESR's general statement: "*not all UCITS should be regarded as automatically non-complex. This is the manifestation of a more generic problem of the architecture of the rules in this space; MiFID Level 1 puts form over substance by setting in*"

stone the qualification of certain financial instruments, regardless of their investment risk profile. On the other hand, MiFID Level 2 establishes qualitative criteria but liquidity and counterparty risk are not part of them.”

But we disagree that ETFs registered as UCITs (“form other substance” indeed) should be automatically deemed “non-complex” for appropriateness purposes. These instruments are more and more popular and are mostly index replicating funds, but most retail clients are unaware that many index replicating ETFs - whether they are registered as UCITS or not – are in reality synthetic funds which do not actually hold the relevant index’s components in their portfolio but mostly fixed income securities and derivatives. These derivatives in turn can generate liquidity and counterparty risks that are undisclosed and therefore unknown to the retail investor.

Therefore, a distinction should probably be made between “full replication” (or by sampling) index replicating ETFs and synthetic index replicating ones which generate other and undisclosed risks for the retail investor.

Another general issue with index replicating ETFs is that their pricing heavily depends on their liquidity and market makers performance. As a result their market bid/offer pricing could significantly differ from the underlying market value of its portfolio.

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

See our response to 22 above.

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 ?

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

Yes

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

We believe CESR’s interpretation of what constitutes frequent opportunities dispose of, redeem, or otherwise realize that instrument is much too vague. As mentioned before, even for many securities automatically considered as “non-complex” by MiFID, there are very few – if any – opportunities for retail investors to dispose of them in a non-penalizing way. This is for example the case of most straight corporate bonds, where the market is not liquid, where often there are no official market makers, no regular quotations constraints and no maximum spreads constraints.

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?

We disagree with CESR’s point of view.

Even for securities automatically deemed as non-complex by MiFID, there are often no prices “*easily accessible through channels that are easy to find for the relevant clients*”. We refer to FIN-USE’s response to CESR’s consultation on non equity markets transparency, which clearly shows that pre and post trade transparency in the fixed income markets, especially the

straight corporate bonds markets does not exist or is very limited for retail investors: market prices are very difficult to find and if found, are often ancient or wrong.

We therefore disagree with CESR proposal *“that prices are publicly available when MiFID pre-trade and post-trade transparency requirements or similar national requirements for financial instruments other than shares apply.”* They do apply for corporate bonds for example, but certainly do not make prices *“publicly available”*.

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

Yes.

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

We believe further clarification is required. One could read “the cost of acquiring the instrument” not as “the cost of the instrument” itself as CESR suggests, but as the charges and costs of the acquisition: fees, commissions, spreads, etc.

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

We do agree in principle, but the current European regulations regarding disclosure of information do not ensure that this is done. We believe only the future “KID” (Key Information Document) for UCITS only may achieve this goal in the future. It is currently certainly not the case of the Prospectus or even the prospectus summary for other instruments covered by MiFID, especially shares and fixed income instruments. As mentioned earlier, for example, liquidity and counterparty risks are often undisclosed.

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

Deposits, loans, mortgages and more importantly life insurance products are indeed not included in MiFID’s scope, which is one of the biggest weaknesses of the “vertical” or “silo” approach of MiFID. The consequence is that life insurance policy holders for example get much less protection features than MiFID products, and certainly not the appropriateness’ test one.

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).

See above response to 31 and all “substitute investment products” as defined and listed in [FIN-USE’s response to the EC call for evidence on the need for a coherent approach to product transparency and distribution requirements for "substitutive" retail investment products.](#)