

ESMA Consultation Paper on draft guidelines on complex debt instruments and structured deposits (ESMA/2015/610) – BVI's position paper

Investment products can entail risks which retail investors should be aware of. The more complex a product is, the more difficult it gets for retail investors to understand these risks. BVI¹ therefore fully supports prudent regulation regarding products which embed a derivative or where the structure makes it difficult for the retail investor to understand the risks. Products included in the scope of MiFID II comprise a broad range. They include highly regulated products such as UCITS where also the issuer is regulated and supervised; however, most of the products covered by MiFID II are unregulated products or even products where neither the issuer nor the product is regulated. Regulated products such as UCITS or other investment funds regulated in a similar way on a national level (i.e. certain retail AIF) integrate already a protective mechanism for investors because of the investment limits, the eligible assets, the requirements regarding liquidity and risk management and in particular the segregation of the funds' assets from the issuers' assets. Unregulated products provide for these mechanisms only on a voluntary basis – if at all. Hence, it is important for retail investors that the complexity of all MiFID II products is analysed thoroughly.

In this respect we would also like to mention that we disagree with ESMA's general statement that all investments in non-UCITS collective investment undertakings should be considered complex, regardless of whether they take the legal form of units or shares. Like other investment products, also AIFs should be allowed to run a complexity test. Many non-UCITS are structured and regulated as retail funds and hence understood as products for retail investors and licensed as such by the competent authorities. Based on the fact that all non-UCITS are per definition alternative investment funds (AIFs), they are often wrongly considered as risky products due to the original aim of AIFMD to regulate hedge funds and private equity funds. In reality, AIFs are all non-UCITS collective investment undertakings and therefore cover a broad range of products including highly regulated retail funds hardly differing from UCITS. For instance, German law provides for four types of retail AIFs which are subject to specific product regulation in addition to the requirements imposed by the AIFMD. This is also recognized by Art. 43 of the AIFMD which gives national flexibility in setting out the conditions under which member states can allow marketing of certain AIFs to retail investors. A broad presumption that all AIFs are per se complex products would also lead to the absurd result that a structured note (certificate) which represents a certain investment strategy without the use of derivatives may end up as non-complex under the complexity test, whereas an AIF representing a similar strategy would have to be considered complex, even though the latter is much less complex in technical terms and comes without issuer risk.

However, as ESMA rightly points out in the draft guidelines (see. No. 11), the classification of products according to MiFID II is only relevant for the question whether a product may be distributed by way of execution only. The regulator only decided on a specific question in Art. 25 para. 4 of the MiFID II. In no case should any decision in the text or its interpretation be regarded as a general understanding of a

¹ BVI represents the interests of the German investment fund and asset management industry. Its 89 members manage assets in excess of EUR 2.6 trillion in UCITS, AIFs and assets outside investment funds. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.



complexity concept. Hence, even in case ESMA would stick to the inconsistent interpretation that highly regulated products have to be considered per se complex, any future regulation on complex products should revisit the understanding of complexity for regulated investment funds.

Finally, it is important to distinguish between products whose performance relies on the performance of an asset or a basket of assets and products which embed a derivative or which incorporate a structure making it difficult for the investor to understand the risks. The performance of most financial instruments depends one way or the other on the performance of other instruments within the market. Even the development of plain equity shares depends on how the market in general develops. It is therefore important to draw the correct line between products simply dependent on the development of other products and products which really are complex because they embed a derivative or contain a complex risk structure.

Question 1: Do you agree with the examples of debt instruments that embed a derivative? If not, which examples do you not agree with, and why not?

We strongly agree with the understanding that in order for the product to be complex, the derivative has to be a component of the financial product, i.e. it has to be part of the instrument. In this respect, we doubt whether indexed bonds, “turbo” certificates and inflation-indexed bonds really embed a derivative. According to our understanding, the repayment of these products relies on the development of an index or price of other instruments. This in itself is not yet a component of these instruments since it is not an integral part of it. The calculation of the repayment formula could be changed easily. Nevertheless, we believe that these products are complex because they have a structure where it is difficult for customers to understand the risk. This is in particular true for products where the repayment is based on a complicated formula.

Question 2: Do you agree with the definition of embedded derivative proposed in the Guidelines in Annex IV? If not, why not?

As pointed out above, the fact that the performance of an instrument depends on the performance of another instrument or asset does not make the product complex. Otherwise in practice even products structured in a simple way like equity shares could be considered complex.

Question 3: Do you agree with the examples of debt instruments that incorporate a structure making it difficult for the client to understand the risk? If not, which examples and why not?

We do not agree with all of the examples. In particular, we strongly disagree with the example regarding debt instruments that are packaged products under the PRIIPs Regulation. This example equalizes products where the structure makes it difficult to understand the risk with products where the performance depends on an underlying pool of assets. Such understanding is not in line with MiFID Level 1 which clearly states that UCITS (except for structured UCITS) are non-complex products as pointed out by ESMA in Footnote 17. UCITS, however, are at the same time packaged products within the meaning of the PRIIPs Regulation. We disagree with ESMA's notion that this could be considered an exemption for packaged products. The simple fact that a product's performance relies on the performance of other assets cannot be the reason for the product to be complex. There is no indication in this regard within MiFID Level 1. In addition, the PRIIPs Regulation recognizes that not all of the PRIIPs are complex (see e.g. recital 1). Further, the example of asset-backed securities shows that the



dependence on underlying assets' performance is not the crucial point: The fact that asset-backed securities rely on the quality of underlying assets does not make it difficult for investors to understand their risks because it is clear that their performance relies on the repayment of the underlying loans. For these products, the risk is difficult to understand because it might not be clear how e.g. the risk that the underlying real property loans and the consumer loans will not be paid back will affect the performance of the asset-backed security.

Question 4: Do you agree with the definition of a structure making it difficult for the client to understand the risk included in the Guidelines in Annex IV? If not, why not?

As pointed out in the answer to Question 3, it is important that the guidelines clearly distinct between packaged products according to the PRIIPs Regulation and products with a structure making it difficult for the client to understand the risks. Hence, ESMA should delete the No. V.14. a) and in particular g) of the draft guidelines.

Question 5: Do you agree with the definition of a structure making it difficult for the client to understand the risk of return of structured deposits and with the relevant examples proposed? If not, why not?

No comment.

Question 6: Do you agree with the definition of a structure making it difficult for the client to understand the cost of exiting a structured deposit before term and with the relevant examples proposed? If not, why not?

No comment.

Question 7: Please provide any specific evidence or data that would further inform the analysis of the likely cost and benefit impacts of the guidelines.

No comment.