Regarding questions 11, 12, 13 and 19 of the CESR paper

It may be difficult, at least in general, to asses whether a given security contains or not an embedded derivative. In a sense any security, even the simplest, being equivalent to many different combinations of derivatives “embeds” derivatives. However, often a reinterpretation of a security as a portfolio of derivatives does not improve our understanding of the security itself and of the risk implied by it. So, for instance, a forward position on a stock is equivalent, by the put/call parity, to a portfolio containing a put and a call position but, obviously, this reinterpretation of the position does not improve its understanding.
On the contrary, the fact that the purchase of a defaultable bond is financially equivalent to the purchase of a non defaultable bond (say a government bond) and the sale of a credit derivative (a CDS like one) on the “Name” issuing the defaultable bond, greatly improves our understanding of the security by splitting it in a position on a presumably very liquid asset and a credit position which can be separatedly valued. In fact, this decomposition is the financial basis of any model for the valuation of credit spreads between bonds.
More: the evaluation of credit spreads observable in the market for defaultable bonds is one of the main sources of information for the valuation of any other credit derivative.
Hence, it seems clear that the purchase of a defaultable bond, being de facto the purchase of a security containing a derivative component is to be considered as the purchase of a security which, in the words of MIFID Art. 19, Par. 6, “embed a derivative”. The suggested interpretation, which seems to the writer of this note coherent with the spirit of the whole MIFID, is that a security embeds a derivative when the understanding of the security is improved if it is decomposed into one or more “primitive” asset and one or more derivative asset, so that a separate description and valuation of the different parts are useful for clarifying the financial implications of the position to the potential purchaser.
This interpretation can help avoiding obvious incoherencies. Suppose, in the above example of a defaultable bond, that this security is considered as not containing a derivative part. If this is accepted, it would become difficult to coherently define any credit derivative as, indeed, a derivative when its basic valuation tool is not defined as a derivative.
In the CESR document note 21 to point 54 mention is made of “A security with an embedded credit default swap” as an example of “money market instruments, bonds and other forms of securitised debt embedding a derivative”. In view of the equivalence of a defaultable bond with a non defaultable bond plus what is the basic form of a CDS, it could be very difficult to accept, at the same time, that a defaultable bond does not contain a derivative component and that a security with embedded CDS does contain such a component.
A better choice seems that of considering both securities as containing a derivative because such a view of each security improves our understanding of its financial meaning.
In this perspective defaultable bonds and, more in general, subordinated liabilities, should be considered as “complex” securities and as such presented, so that clients, in MIFID words (Art. 19, Par. 3) be “reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is offered and, consequently, to take investment decisions on an informed basis”.