



European Securities and
Markets Authority

Final Report

Guidelines on complex debt instruments and structured deposits



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Acronyms and definitions used

CP	Consultation Paper
DP	Discussion Paper
EC	European Commission
EEA	European Economic Area
ESMA	European Securities and Markets Authority
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC
EU	European Union
MiFID or MiFID I	Markets in Financial Instruments Directive – Directive 2004/39/EC of the European Parliament and the Council
MiFID II	Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU
MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments and amending Regulation (EU) No 648/2012
MS	Member State
NCA	National Competent Authority
OJ	The Official Journal of the European Union
PRIIPs	Packaged retail and insurance-based investment products
SMSG	Securities and Markets Stakeholder Group
UCITS	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009, on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
BRRD	Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council

1 Executive Summary

Reasons for publication

1. Article 25(4) of Directive No 2014/65 (MiFID II) allows investment firms, subject to certain conditions, to provide investment services that only consist of execution or reception and transmission of orders without obtaining client information necessary to assess the appropriateness of the service or product for the client (so-called “execution-only”). One of the conditions for the application of Article 25(4) of MiFID II is that the services relate to products which are “non-complex” for the purpose of the same paragraph.
2. In order to identify some of the products for which execution-only services cannot be provided, Article 25(10) of MiFID II requires ESMA to develop, by 3 January 2016, guidelines for the assessment of:
 - (i) bonds, other forms of securitised debt and money market instruments incorporating a structure which makes it difficult for the client to understand the risk involved, and
 - (ii) structured deposits incorporating a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term.
3. On 24 March 2015 ESMA launched a consultation on the relevant draft guidelines¹ in order to explain its rationale and gather input from stakeholders on the issues covered by Article 25(10) of MiFID II. The Consultation Paper (CP) also set out draft guidelines on the concept of embedded derivative which is equally important for the correct classification of debt instruments (bonds, securitised debt and money market instruments) as either “complex” or “non-complex”. The consultation period closed on 15 June 2015.
4. ESMA received 32 responses. The answers received are available on ESMA’s website unless respondents requested otherwise. ESMA also sought the advice of the Securities and Markets Stakeholder Group’s (SMSG). This paper summarises and analyses the responses to the CP and explains how the responses have been taken into account. ESMA recommends reading this report together with the CP published on 24 March 2015 to have a complete view of the rationale for the guidelines.

¹ ESMA/2015/610.

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5. Section II briefly illustrates the guidelines following the responses to the consultation. Section III contains the Annexes: Annex I provides the Summary of questions raised in the CP, Annex II describes the legislative mandate, Annex III reports the cost-benefit analysis, Annex IV explains the detailed feedback on the responses received to the CP, Annex V contains the final text of the guidelines and includes a summary of a non-exhaustive list of examples of complex products for the purpose of these guidelines.

Next steps

6. The guidelines in Annex V will be translated into the official EU languages and published on the ESMA website. The publication of the translations will trigger a two-month period during which NCAs must notify ESMA whether they comply or intend to comply with the guidelines.
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2 Overview

7. Article 25(4) of MiFID II allows investment firms to provide order-handling services (reception and transmission of orders, as well as execution of orders on behalf of clients) without performing the appropriateness test described in Article 25(3). In addition to some other conditions, Article 25(4) requires that such services relate to specific types of products – usually termed “non-complex” – including certain debt instruments as well as certain structured deposits.
8. MiFID II also identifies conditions under which these products cannot be classified as “non-complex” with the result of narrowing the list of non-complex instruments currently regulated by MiFID I.
9. Article 25(10) of MiFID II requires ESMA to develop, by 3 January 2016, guidelines for the assessment of:
 - a. bonds, other forms of securitised debt and money market instruments incorporating a structure which makes it difficult for the client to understand the risk involved (instruments referred to in Article 25(4)(a)(ii) and (iii)), and
 - b. structured deposits incorporating a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term (instruments referred to in Article 25(4)(a)(v)).
10. On 24 March 2015 ESMA published a CP which set out draft guidelines as required by Article 25(10) of MiFID II and also addressed the concept of embedded derivatives that is important for the correct classification of debt instruments as either “complex” or “non-complex” for the purposes of Article 25.
11. Following the analysis of the responses to the consultation, ESMA has modified the guidelines and reviewed some of the examples highlighted into the CP. In particular, according to ESMA’s final opinion the following instruments should not fall under the category of instruments embedding a derivative or presenting a structure which makes it difficult for the client to understand the risk:
 - a. inflation-linked notes;
 - b. debt instruments denominated in a currency different from the one of the jurisdiction (or a currency that is pegged to the currency of the jurisdiction) where the investment services are provided;
 - c. structured deposits in which the return is linked to a currency which is not the one of the jurisdiction where the structured deposit is offered;
 - d. debt instruments that would be regarded as “packaged products” by virtue of Regulation (EU) 1286/2014 since they should be classified as “complex”



instruments in accordance with criteria applicable to any other financial instruments.

12. ESMA has clarified that instruments with complex mechanisms to determine or calculate the return should be deemed complex in accordance with the guidelines since they incorporate a structure making it difficult for the client to understand the risk of the instrument.
13. A new example of structured deposit incorporating a structure making it difficult for the client to understand the risk of return has also been added. More specifically, ESMA considers that a structured deposit where the credit institution has the unilateral right to terminate the agreement before term should be deemed complex.
14. In relation to the other types of debt instruments and structured deposits, ESMA has confirmed the classification proposed in the CP, as summarised in a specific table attached to the Guidelines, and provided additional clarifications as resulting from the feedback under Annex IV.



3 Annexes

3.1 Annex I

Summary of questions

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?

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

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?

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?

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?

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?

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.



3.2 Annex II

Legislative mandate

15. Article 16 of Regulation (EU) No 1095/2010 of the European Parliament and of the Council (ESMA Regulation) empowers ESMA to issue guidelines and recommendations addressed to competent authorities or financial market participants, with a view to establishing consistent, efficient and effective supervisory practices within the ESFS, and to ensuring the common, uniform and consistent application of Union law.
16. Article 25(4) of MiFID II allows investment firms to provide investment services that only consist of execution or reception and transmission of orders without obtaining the information or making the determination provided for in Article 25(3). In addition to certain other conditions, Article 25(4) requires that such services relate to specific types of products – usually termed “non-complex” – including certain types of debt instruments (bonds, other forms of securitised debt and money market instruments) as well as certain types of structured deposits.
17. Furthermore, Article 25(10) of MiFID II requires ESMA to develop, by 3 January 2016, guidelines for the assessment of:
 - a) bonds, other forms of securitised debt and money market instruments incorporating a structure which makes it difficult for the client to understand the risk involved (instruments referred to in Article 25(4)(a)(ii) and (iii));
 - b) structured deposits incorporating a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term (instruments referred to in Article 25(4)(a)(v)).

3.3 Annex III

Cost-benefit analysis

18. The CP set out draft guidelines on issues judged important for the correct classification of MiFID debt instruments (bonds, securitised debt and money market instruments) and structured deposits as either “complex” or “non- complex”. The criteria proposed in this Final report and the resulting classification as “complex” or non-complex debt instruments or structured deposits will be relevant with regard to Article 25(4) of MiFID II.
19. The cost-benefit analysis published with the CP presented a qualitative assessment of the potential costs and benefits of the proposed guidelines.
20. To a large extent the draft ESMA guidelines are built on the previous work from CESR which provided a detailed steer to firms as to what should and should not be regarded as a complex instrument and therefore what could and could not be provided on an “execution-only” basis.
21. Furthermore, MiFID II has narrowed the area for non-complex financial instruments mentioned under MiFID I. In particular, in accordance with MiFID II:
 - i. In relation to bonds and similar debt instruments, only those which are admitted to trading on a regulated market or on an equivalent third country market or on a MTF can potentially be deemed non-complex ² (excluding those instruments which embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved),
 - ii. The concept of “structure which makes it difficult for the client to understand the risk” for debt instruments (including money market instruments) is new,
 - iii. Structured deposits are now in the scope of MiFID II (for this particular provision and a number of others) and are defined under Article 4(1)(43),
 - iv. The reference to a “structure which makes it difficult for the client to understand the risk of return” of a structured deposit and to a “structure which makes it difficult for the client to understand the cost of exiting” a structured deposit are also new.
22. Considering that a large majority of financial instruments were already covered by the previous CESR guidance on complex financial instruments and in light of the new provisions under MiFID II, these guidelines will apply to or cover a relatively limited universe of additional financial instruments. Additional regulatory conditions, including

² Such listed or traded financial instruments must fulfil the other criteria listed in Article 25(4) of MiFID II.

that the service is provided at the initiative of the client, will continue applying to the provision of services in accordance with Article 25(4) MiFID II. Therefore, ESMA anticipates moderate additional costs for firms (and potentially for some investors) arising as a result of these Guidelines.

23. On structured deposits, the inclusion of these products under MiFID II is new and will imply the application of MiFID II rules as a result of the legislative inclusion in the scope of the new directive. The general criteria for the classification of complex structured deposits are already identified in MiFID II. These guidelines only propose detailed factors for the application of the MiFID II general criteria and should not have a significant additional impact on firms.
24. It is therefore anticipated that these guidelines will generate limited additional compliance costs for firms with moderate incremental costs incurred where firms must modify their internal arrangements for the distribution of certain investment products and training. For example, they will need to update their training of staff to ensure that in light of these guidelines, only non-complex instruments are provided in accordance with Article 25(4) of MiFID II (so-called “execution-only” basis). Since firms should normally already incur the cost of training new staff and updating the training (and training material) for existing staff, there would again be moderate incremental impact on a firm’s budget to design training for staff on additional products considered to be complex.
25. The benefits of these guidelines, which in ESMA’s view largely outweigh costs, arise principally from offering further protection to investors and minimising detriment associated with any debt instrument being sold to investors where they are unable to assess the risk involved or, in the case of structured deposits, cannot assess the risk of return or the cost of exiting the product. Furthermore, the guidelines further articulate what products are considered complex and therefore cannot be sold on an execution-only basis.
26. Responses to the consultation do not modify the analysis presented above. ESMA notes (and agrees with) some respondents’ comment about the need to ensure a harmonised implementation of the execution-only regime among EU.

3.4 Annex IV

Feedback on the consultation paper

27. In the CP ESMA explained the rationale of the guidelines and sought to gather input from stakeholders. In order to provide a consolidated approach to the classification of debt instruments for the purpose of Article 25 (4)(a)(ii) and (iii) of MiFID II, the CP set out draft guidelines both on the concept of the structure making it difficult for the client to understand the risk of a debt instrument and on the definition of embedded derivative.
28. A number of respondents pointed out that ESMA had rightly emphasised that the Guidelines only serve to determine which types of debt instruments and structured deposits can be sold on an execution-only basis, versus those that are subject to the appropriateness test. Several respondents also emphasised the need to achieve harmonised implementation of MiFID in this area. Very few respondents criticised ESMA's proposal to address the concept of embedded derivative for debt instruments and some respondents explicitly supported ESMA's proposal in this direction noting that it is of the utmost importance to address this issue.

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?

General Remarks

29. A majority of respondents provided feedback to Question 1 to communicate their concern over the treatment of one or more specific instruments which have been described as complex in the CP. While some respondents offered support for the examples of debt instruments embedding a derivative, in many cases modifications were suggested to one or more examples of instruments mentioned in the CP. Four respondents offered unqualified support for all of the examples of debt instruments embedding a derivative. Several others focused their criticism on inflation-linked bonds.

Specific Comments

30. A number of industry respondents (over a third) argued against one or more of the examples included in the CP as examples of instruments which embed a derivative.

Inflation-linked bonds

31. The examples of inflation-linked bonds and callable and puttable bonds came under particular criticism. However, convertible bonds were also highlighted by a few of respondents as an area in need of refinement in the guidelines.
32. One trade association reasoned that the link between the coupon/principal payment of an inflation-linked bond and the inflation rate does not constitute an embedded

derivative. It further argued that since inflation-linked bonds operated much like Floating Rate Notes (FRNs), inflation-linked bonds should be treated the same way as FRNs are in the CP i.e. as non-complex. This view on inflation-linked bonds was echoed by other respondents. The same respondent also stressed that since in their view inflation-linked bonds do not embed a derivative they should be considered under the section 'incorporating a structure making it difficult for the client to understand the risk' where, compared to other instruments, they are far more straightforward for an average retail investor to comprehend.

33. Other industry respondents stressed that since there is a 'linear' relationship based on a reference index constructed by state or supranational institutions which cannot be subject to manipulation and which are familiar to investors, these index-linked instruments should not be considered as 'complex'.
34. One European investor body objected to inflation-linked bonds being classed as complex (whether because they embed a derivative or because they incorporate a structure making it difficult for the client to understand the risk) on the basis that retail investor access to these inflation hedging products would be compromised as a result of the costs they would necessarily incur from being submitted to the appropriateness requirements. Further, they argued that, if these instruments are to be classed as complex because of the 'inflation feature', then ESMA should, in the interests of consistency, classify ordinary bank accounts/current accounts which accrue interest in a similar manner.
35. Another respondent advised that inflation-linked bonds should be excluded from the list of instruments deemed to embed a derivative on the grounds that they '*are simple instruments issued by public treasuries*'
36. Other respondents stipulated that while they did not agree that inflation-linked bonds embed a derivative, they nevertheless did think that these instruments incorporate a structure that would make it difficult for the client to understand the risk.

Contingent convertible bonds

37. Whilst some respondents explicitly agreed with the view that contingent convertible bonds (CoCos) should be considered as 'embedding a derivative', some nevertheless thought the definition of these instruments offered in the CP (debt securities where the principal amount may be cancelled, reduced, or converted to equity) is drawn too widely and consequently includes *any* debt instrument issued by a credit institution or investment firm where the 'resolution authorities' have power to convert debt into shares. This same respondent argued that it is inappropriate to categorise any debt instrument as embedding a derivative just because a 'resolution authority' could convert it into shares or cancel it in the case of full write-down of principal and therefore, the guidelines should be amended to clarify that only contingent convertible bonds should be considered as embedding a derivative. This view was echoed by three other respondents.

Callable and puttable bonds

38. There was no consistent/uniform reason put forward by those respondents who objected to the CP categorization of callable or puttable bonds as embedding a derivative. For instance, several respondents argued that the definition of a derivative as set out in MiFIR and MiFID includes instruments with options related to the underlying assets such as securities, currencies or commodities whereas the option in a callable or puttable bond relates to the maturity date of the bond rather than on the underlying asset. A few respondents raised the question of the treatment of several corporate bonds that contain a specific early redemption feature, notably a standard 'tax call' allowing the issuer to redeem a debt instrument in case of changes in the tax legislation applicable to the bond.

ESMA's response

39. ESMA notes that many respondents broadly supported a number of examples of debt instruments embedding a derivative, including convertible or exchangeable bonds, indexed bonds and "certificates" (in the usual market meaning of the term that corresponds to "structured note"), warrants, contingent convertibles and credit-linked notes. Significant opposition arose however with respect to the classification of inflation-linked bonds, including from representatives of investors.
40. Regarding inflation-linked bonds, ESMA acknowledges that these bonds are widely used by retail investors as a hedge against inflation and that the average retail investor normally understands sufficiently the mechanism involved. Furthermore, ESMA is aware that, even in relation to International Financial Reporting Standards (IFRS), which tackle a similar issue under the accounting standards viewpoint, a debate is taking place on the treatment of inflation-linked bonds. In light of the above ESMA considers that, for the purpose of these guidelines, the link between the coupon or principal payment and the inflation rate is not to be regarded as an embedded derivative within the meaning of the present Guidelines. Therefore ESMA concludes that these instruments should not be deemed complex.
41. In relation to contingent convertible bonds, ESMA would like to mention that these hybrid instruments can be called to absorb losses in accordance with their contractual terms (when the capital of the issuing bank falls below a certain level). This contractual mechanism makes the CoCos embed a derivative and therefore complex. For other types of debt securities that may absorb losses by virtue of statutory provisions, please see paragraph 72.
42. Regarding callable and puttable bonds, ESMA confirms the position already expressed by CESR in its Q&A on "MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements"³ in accordance with which

³ CESR/09-559, para. 46.

callable and puttable bonds should be regarded as “bonds embedding a call or put option, with the price of the bond taking these components into account. This means that such bonds should not be regarded as non-complex instruments for the purposes of the appropriateness requirements”. ESMA therefore believes that callable and puttable bonds should be considered as complex instruments, in line with the position already expressed by CESR.

43. ESMA has however analysed respondents’ comments on the ‘tax clause’ feature, ie clauses commonly used when issuing corporate bonds that enable the issuer to redeem the debt instruments in the case of future changes in the tax law which impact on the issuer in a way that the issuer would not be able to make future payments of principal or interest without having to pay additional amounts of income tax. ESMA acknowledges that these clauses are common and relatively simple. Therefore ESMA concludes that the sole inclusion of standard tax clauses should not make an instrument complex for the purpose of the Guidelines.

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

General Remarks

44. Around half of the 32 respondents to the CP provided feedback to Question 2 on the definition of an instrument ‘embedding a derivative’. A majority of these respondents broadly agreed with the definition proposed in the CP. However, a handful of respondents explicitly stated they were opposed to the definition contained in the CP, arguing that the definition was ‘too broad’ to achieve harmonisation in the classification of debt instruments or contradicted definitions in other EU legislation, namely, the UCITS implementing directive. The feedback received in response to this question was very diverse.

Specific Comments

45. A minority of respondents disagreed with the proposed definition.
46. Respondents opposed to the definition in the CP argued that it is ‘too broad’ and ‘too vague’. Two respondents stated they found it difficult to reconcile the definition included in the main body of the CP and the shorter guidelines in Annex IV and so questioned the clarity around ‘*what ESMA considers as guidelines*’.
47. Another respondent in addition to finding the definition ‘too broad’ and ‘too vague’ also commented that since in their view ‘inflation protection’ is not an embedded derivative, ESMA should define the concept of ‘embedded derivative’ much more precisely.

48. An argument was made by another respondent that it is not enough that the performance of an instrument merely depends on the performance of another instrument/asset for it to be deemed complex and so questioned the validity of the definition and corresponding classification of certain instruments as 'complex'.
49. Finally, a respondent argued that the definition is inconsistent with the one included in Article 10 of the UCITS implementing Directive⁴.
50. ESMA did receive suggestions for modifying the current definition from some respondents. For instance, one respondent proposed that the definition be expanded upon to ensure that all instruments which contain a guarantee of capital repayment are excluded from the scope of the guidelines and requested that this be explicitly stated in the definition. The justification offered for such exclusion is that it would be consistent with the reading of Article 38 of the current MiFID implementing directive (Directive 2006/73/EC).
51. Another respondent suggested that only '*negative*' revision of cash-flow would mean a derivative is embedded.

ESMA's response

52. ESMA notes that the majority of respondents accepted the proposed definition and that only a small minority offered drafting proposals to amend it. The proposed definition can be applied to a variety of situations; ESMA has illustrated how the definition applies in practice with a number of non-exhaustive examples. ESMA has therefore confirmed the approach proposed in the CP.
53. As already stated at paragraph 13 of the CP, the definition of embedded a derivative proposed in the draft Guidelines for the purpose of the appropriateness test under Article 24(4) of MiFID II is similar to other existing definitions. With reference to the definition provided by Article 10 of UCITS implementing directive (Directive 2007/16/EU), ESMA notes that the notion of instruments embedding a derivative concerns the definition of certain eligible assets for investment by UCITS and includes an additional reference to the risk profile of the instrument as a consequence of the embedded derivative. Differently from the UCITS context, the concept of "embedded derivative" provided under Article 25(4) of MiFID II aims at identifying instruments which are complex in the perspective of investors (irrespective of any reference to the risk profile of the instrument).
54. ESMA notes the request to exclude from the scope of the guidelines the instruments which contain a guarantee of capital repayment or where a positive revision of cash flows results from the embedded derivative. ESMA notes however that the existence of

⁴ Commission Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions.

such guarantee or the consequences in terms of positive or negative revision of cash flows is not relevant for the qualification of a debt instrument as embedding a derivative in accordance with Article 25 of MiFID.

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?

General Remarks

55. Question 3 of the CP attracted several comment from across industry most of which were either negative in tone or called for reconsideration of some of the examples of debt instruments incorporating a structure making it difficult for retail clients to understand the risk (the latter by far being the category that most respondents fall into).

Specific Comments

56. Whilst three respondents explicitly said they did support the list of debt instruments incorporating a structure making it difficult for retail clients to understand the risk, a majority of respondents took issue with one or more of the instruments included in this category.

57. The examples of debt instruments which attracted some criticism were: debt instruments denominated in a currency different from the one of the jurisdiction where the investment service is provided (this was by far the main point of contention with 11 respondents objecting); debt instruments issued by a SPV; PRIPS; debt instruments structured in a way that may not provide for a full repayment of the principal amount, asset-backed securities. Subordinated debt instruments were also highlighted by respondents as areas of difficulty (these all attracted the same degree of criticism with around 3-5 respondents objecting to their inclusion in the list of debt instruments incorporating a structure making it difficult for retail clients to understand the risk).

58. Respondents requested that ESMA clarify the following terms which they felt were ambiguous and subjective: 'niche markets', 'unfamiliar or unusual underlying'. A number of respondents advised that the guidelines should focus on whether information on an underlying component, variable or index was 'transparent' and 'widely available' rather than whether it is 'unusual' or 'unfamiliar'. These respondents were concerned that debt instruments with a new or innovative underlying but which are otherwise straightforward to understand would be unfairly categorised as 'complex'.

Debt instruments denominated in a currency different from the one of the jurisdiction where the investment service is provided

59. Many respondents objected to this as a criterion for classifying a debt instrument as 'complex'. The reasons put forward were manifold, ranging from the inconsistent treatment of a company's debt and equity when both were issued in the same non-

domestic currency, to the discrimination against non-euro zone EU members (indeed, some respondents said that such an approach risks undermining the aims of the CMU) to the inadequate explanation contained in the CP to justify such a classification of debt instruments as complex.

60. The main argument against the inclusion of this criterion to classify a debt instrument as 'complex' was that it would result in the inconsistent treatment of Euro-zone and non-Euro-zone firms and investors since it would mean that a bond issued in euros would be classified as complex to a UK investor but non-complex to a French retail investor and viceversa. The consequence of such an approach would be to fragment European markets and hinder the participation of retail investors in capital markets.
61. Another frequent challenge against the inclusion of this criterion was that many retail customers are familiar with major international currencies. Specifically, respondents pointed out that ordinary retail customers are familiar with the concept of currency fluctuation; they may open bank accounts denominated in different currencies; they buy bonds denominated in dollars. A direct consequence of classifying a debt instrument as complex because it is denominated in a currency that differs from the one in the jurisdiction where the investment service is provided, according to one respondent, would be the creation of an 'un-level playing field with regard to the provision of services and restriction of customer choice and access to products and providers in certain jurisdictions.

Debt instruments structured in a way that may not provide for a full repayment of the principal amount

62. Some respondents also raised concern that a debt instrument would be viewed as 'complex' as a consequence of the possibility of a decision of a resolution authority. These respondents argued that, according to the draft guidelines, any debt instrument (even plain vanilla bonds) issued by credit institutions would be classified as complex because it is potentially subject to a resolution decision. Comments on this category of instruments should be read in conjunction with those expressed for contingent convertible instruments (paragraph 37).

Debt instruments issued by a SPV

63. One respondent requested the deletion of this criterion arguing that issuances by SPVs would be caught by the categorization of ABS. Failing this, the same respondent requested that ESMA reconsider attributing complexity to 'denomination' and 'legal name' of a SPV since they do not constitute the reasons of debt instruments' complexity. According to this respondent features like collateralisation or asset segregation would more likely make an instrument difficult to understand.
64. Two respondents queried whether a SPV which is '*unconditionally*' and '*irrevocably*' guaranteed by the sponsor, would be clearly exempted from the criteria used to determine whether a retail investor would struggle understand risk except if they

combine this feature with another one that actually embeds a risk that is difficult to be understood.

65. Other respondents argued that 'denomination' and 'legal name' were not features which added complexity to a debt instrument. They argued that where a SPV's legal name uses the name of the guarantor it should be made clear that the debt instrument is non-complex and no appropriateness test is required.

PRIIPS

66. Some respondents challenged the inclusion of PRIIPS as a criterion by which the complexity of debt instruments can be determined. While one respondent requested that ESMA provide more detailed arguments as to why PRIIPS are categorized as complex, the main objection raised against the inclusion of these instruments in the list of debt instruments incorporating a structure making it difficult for the client to understand the risk' is the inconsistent categorization of some (PRIIPS) products as complex and others as non-complex even though their respective performance relies on an underlying pool of assets. To highlight this point respondents noted that while UCITS are viewed as a 'packaged products' and therefore *should* be viewed as 'complex' in the guidelines, MiFID clearly states UCITS are non-complex products for the purposes of Article 25(4).

Asset-backed securities

67. Several respondents raised objections to the classification of the ABS as complex debt instruments. Some respondents argued that ESMA has adopted an inconsistent approach in its treatment of ABS and covered bonds, reasoning that covered bonds and ABS share many common economic features/financial purpose and as such, should be treated in an equivalent manner. Further, say these respondents, by treating ABS as complex and covered bonds as non-complex, ESMA risks an un-level playing field by imposing a more favourable regime for those jurisdictions in which covered bonds are widely used as an asset-financing technique compared with those jurisdictions where traditional asset securitisation is more common.

Subordinated bonds

68. The main objection raised by a number of respondents in relation to subordinated debt was that subordination makes a debt instrument more 'risky' rather than 'complex' and that they generally did not see that subordination would necessarily be a complex concept for retail investors to understand.

Other specific remarks

69. *Leverage*: This criterion prompted very little comment with just one respondent requesting greater clarification around this concept. They argued that whether an investor loses or gains at multiples to their original investment is immaterial since by

extension this would mean that *‘any instrument traded in the secondary market below the initial investment would have to be considered a complex product’*.

70. *Debt instruments with complex guarantees of repayment of principal*: Several respondents requested that this concept be clarified in general. One respondent made the point that under the circumstances where a guarantee includes collateralised assets which must be sold prior to the calling of the guarantor, the appropriateness test is not required.

ESMA’s response

71. The classification of all debt instruments denominated in a non-domestic currency was particularly challenged. ESMA understands the concerns expressed during the consultation and accepts that the explicit denomination of an instrument in a non-domestic currency does not turn the security into a “debt instrument with an unfamiliar or unusual underlying”, as mentioned in the CP. Therefore ESMA accepts that the fact that a debt instrument is denominated in a non-domestic currency is not deemed sufficient to qualify the instrument as a complex one.
72. Regarding debt instruments that may not provide for a full repayment of principal, ESMA would first of all clarify that it was never intended to classify all debt securities as complex because of the possibility that the issuer may become insolvent. The purpose of the criterion under paragraph 21 (vii) of the CP was to address those circumstances where a retail investor is unclear about whether or not the repayment of their principal will take place because of the complexity built into the structure of these instruments including when this is the result of legal provisions applicable to the instruments.
73. Under paragraph 41, the treatment of CoCos is dealt with. In particular, in the case of CoCos, an issuer could structure an instrument to absorb potential losses should its capital reserves fall below certain capital thresholds. The situation is not substantially different, in the perspective of investors, when a debt instrument may absorb losses as a result of a discretionary decision of a resolution authority. The understanding of the conditions under which a financial institution may be likely to fail and which trigger a loss-absorbency action would be very demanding. This mechanism confronts the retail investors with an added layer of complexity which demands an understanding of the complex circumstances under which their investment would be at risk. It should be considered that the conditions regulating the bail-inable instruments have an impact on the functioning of these instruments and therefore on their complexity from the point of view of the investor, which is the point of view of Article 25 (4) of MiFID II. It is the view of ESMA that where a degree of ‘uncertainty’ exists which prevents retail investors from properly gauging whether their investments in certain debt instruments are at risk either because the firm or a prudential authority exercises discretion to partially or fully write-down (or convert into equity) the bond-holders investments, then these instruments would incorporate a structure which should appropriately be deemed as ‘complex’. Therefore, ESMA would like to clarify that, for the purpose of these Guidelines, all bail-inable debt instruments are to be deemed complex. This includes all debt instruments

which are part of the eligible liabilities under the BRRD with the exclusion of those mentioned under Article 44(2) of the BRRD. ESMA notes that the mentioned criterion should also apply to debt instruments issued by third country entities.

74. Regarding debt instruments issued by an SPV, ESMA considers that the name of the instrument and/or of the SPV may in certain circumstances be confusing for the retail investor and increase the difficulty of understanding the associated risks, i.e. where the investor may be led to think that the instruments is issued or guaranteed by an entity different from the one it is actually issued or guaranteed by.
75. For the sake of clarity, ESMA notes that this is not the case where the repayment of the principal amount is fully and unconditionally guaranteed by the sponsor, e.g. where company ABC UK (that the retail investor is likely to be familiar with) fully and irrevocably guarantees the payment of a bond issued by ABC BVI. Where there is no such guarantee, the investor is likely to think nonetheless that the credit risk relates to ABC UK and not to the SPV in BVI.
76. ESMA has also deleted the reference to the PRIIPs Regulation since products that would be classified as PRIIPS should be deemed complex under the same criteria as all other debt instruments, for the purpose of Article 25(4) of MiFID II.
77. ESMA would like to confirm the classification of ABS as complex instruments as already stated by CESR in 2009 considering that the structure of these instruments can affect the ease with which the risk attached to the product may be understood⁵. Concerning the comparison between ABS and covered bonds, ESMA would like to recall that, in its CP, reference is only made to “traditional covered bonds”; as already clarified by CESR⁶, structured covered bonds (ie bonds backed by a pool of assets which is off-balance sheet and held on a corporate structure separate from the financial institution) are similar to ABS and should be treated in the same way for the purpose of the MiFID appropriateness requirements. While confirming this approach, ESMA is aware of the public consultation recently launched by the European Commission on “Covered bonds in the European Union”⁷ and reserves the possibility to come back on the classification of this category of instruments for the purpose of Article 25(4) of MiFID II.
78. Regarding subordinated bonds, ESMA confirms the position expressed in CP where it underlined that the holder of a subordinated debt instrument is in a less favourable position than the holder of an ordinary debt instrument, since the re-imbursement of the latter is not subordinated to the prior reimbursement of the debt held by others. This less favourable position is difficult to understand for the average retail investor and therefore these instruments should be considered as complex.

⁵ CESR/09-559, paragraphs 35-37.

⁶ CESR/09-559, paragraph 49.

⁷ http://ec.europa.eu/finance/consultations/2015/covered-bonds/docs/consultation-document_en.pdf

79. ESMA notes the comments on debt instruments that incorporate a guarantee by a third party of the repayment of principal and confirms the position expressed in the CP according to which a debt instrument should be considered complex for the purpose of the appropriateness test where the guarantee mechanism is structured in a way which does not enable the investor to assess accurately how such a guarantee mechanism affects the risk exposure.
80. Finally ESMA judged it appropriate to introduce a reference to the complexity of the mechanisms to determine or calculate the return of an instrument. For the sake of clarity, ESMA believes that debt instruments structured in such a way that the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument either because certain pre-determined threshold conditions are met or because certain time-points are reached are deemed to be complex.

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?

General Remarks

81. Just under half of respondents offered feedback to this question. Of these, three respondents explicitly stated that they did not agree with the definition of a structure making it difficult for the client to understand the risk. The majority of respondents recommended that further clarification is required around some terms such as 'average retail client' and 'unusual or unfamiliar underlying' contained in the current definition (see specific comments below).

Specific Comments

82. Several respondents noted that the term *average retail client* was too wide and vague to be useful. One respondent stipulated that it was impossible to determine which instruments pose a difficulty for the average retail client to understand as the CP does not adequately define what is meant by *average retail client*. Another respondent argued that the current definition was vague and lacked legal certainty. They maintained that classification of an instrument as either 'complex' or 'non-complex' turns on what knowledge the *average retail client* can be assumed to have and that this would necessarily have to be assessed on a case-by-case basis.
83. The respondent also made the point that whilst the CP (Annex V Guidelines, para 13) stipulates that a structure making it difficult for the average retail client to understand the risk should be one where the characteristics of the debt instrument differ substantially from those of ordinary, simple bonds, the examples in the CP indicate instead that an appropriateness test would be required for debt instruments which do not differ substantially from ordinary bonds.

84. A number of respondents said that the guidelines should focus on whether information on an underlying component, variable or index is ‘transparent’ and ‘widely available’ rather than whether it is ‘unusual’ or ‘unfamiliar’. These respondents were concerned that debt instruments with a new or innovative underlying but which were otherwise straightforward to understand would be disproportionately affected. An amendment was proposed to the wording of the guideline to take account of this (one respondent proposed the following addition to guideline VII(e): *”and about which appropriate information is not publicly available”*)
85. However two respondents argued that any concerns around the familiarity or understanding of certain underlying will largely be mitigated through the application of the Benchmark Regulation once it comes into force.

ESMA’s response

86. ESMA has deleted the reference to the concept of “average retail investor” contained in the general definition of complex debt instruments (deletion of paragraph 13 of the draft guidelines) and in the general definition of structured deposits with complex return (paragraph 15 of the draft guidelines). ESMA has also deleted the reference to “ordinary, simple bonds” since it does not seem, judging from respondents’ replies, that these general definitions were helpful in practice.
87. ESMA has however retained the reference to average retail investors in relation to the specific category of debt instruments with an underlying that is unusual or unfamiliar from the perspective such an average retail investor. ESMA notes that the concept of “average retail” client and “average member” of a group to whom information is addressed are already used in the MiFID I implementing directive. ESMA believes therefore that this criterion is still useful when referring to the specific situation of unusual or unfamiliar underlying which makes it difficult for the client to understand the risk for the relevant financial instrument.
88. ESMA would furthermore note that the simple fact that information about the underlying is publicly available would not suffice to conclude that it may be deemed familiar to the average retail investor

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?

General remarks

89. Approximately half of the respondents provided feedback on the draft guidelines devoted to complex structured deposits. Most respondents substantially agreed with the examples and the definition, some respondents underlined their concerns about the definition of a complex structure that seems too vague and risks hampering legal certainty and level playing field.

90. It was also noted that the guidelines risk being too general and not sufficiently clear to guarantee a consistent implementation and application across Member States.

Structured deposits where more than one variable affects the return received

91. Few respondents pointed out that an instrument should not be considered complex if the reference to more than one variable or the introduction of more than one reference date involves an advantage for the investor.

Structured deposits where a complex relationship exists between the relevant variable and the return

92. With reference to the example where the return on a structured deposit is linked to an in-house index or other non-public benchmark, two respondents noted that, depending on the degree of complexity of the underlying index, the provision of a sufficient level of transparency about calculation methods and composition of the underlying index could educate average retail investors about the payoff characteristics of the product.
93. Two respondents disagree with the consideration of when “a complex relationship exists between the relevant variable and the return” to include instruments where the return is calculated through averages. Simple averages on public benchmarks and underlying can be calculated by elementary educated retail investor so their inclusion should not be unduly limited. This could limit the use of features that protect for the medium term investor against unexpected short term volatility.

Structured deposits where an unfamiliar or unusual variable is involved in the calculation of the return

94. Some respondents raised some objections with reference to the example where the return on a structured deposit is linked to a ‘currency which is not one of the jurisdictions where the structured deposit is offered’. One of them proposed an amendment to clarify whether currency pairs are included in the list for the example, asking to add “or a currency pegged to the currency of the jurisdiction” in order to embrace both national currencies and EUR.
95. One respondent asked for the deletion of the reference to the average retail investor in the “relevant Member State” provided in the draft Guidelines when assessing the complexity of debt instruments, since this would risk creating discrepancies between retail investors within the EU.

Other remarks

96. It was also argued that a further condition should be added to the criteria of factors that make a structured deposit complex, namely when a contract gives the firm the unilateral right to terminate the agreement early depending on how the deposit is performing. It is noted that in such circumstances, the client generally is unaware of this provision and the conditions that need to be met for this to be triggered.



ESMA's responses

97. Regarding structured deposits where more than one variable affects the return, ESMA considers that having more than one variable is likely to make it difficult for the client to understand the risk of return, and therefore retains this criterion. ESMA considers that the structure of the product is deemed complex also in these cases, since the relevant concept of complexity for the purposes of Article 24 and 25 of MiFID II refers to the difficulty for retail investors to understand the risks (not to the risks *per se*). For the sake of clarity, ESMA believes that structured deposits with a complex mechanism to calculate the return should also be deemed complex. This may be the case when the deposit is structured in a way that the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument.
98. ESMA notes the comment that simple averages of public benchmarks should not necessarily make a product complex. ESMA agrees with this analysis, but does not consider the criterion should be changed as it considers that it is sufficiently clear that the use of simple averages (i.e. a single average of a public benchmark) would not automatically mean that a product is deemed 'complex'.
99. ESMA also notes the concerns of several respondents who raised objections to structured deposits linked to currencies that are not of the jurisdiction where the product is offered. ESMA agrees with concerns about the unintended impact on the single market, and therefore deletes this reference.
100. In order to not create discrepancies between retail investors within the EU, ESMA decided to amend the text of the guidelines deleting the reference to the average retail investor in the "relevant Member State" proposed in the draft Guidelines.
101. ESMA notes the comment referring to structured deposits where the firm has the unilateral right to terminate the agreement early depending on how the deposit is performing and agrees that the existence of this right should be added to the criteria of factors that make a structured deposit complex.

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?

General remarks

102. Less than half of respondents provided feedback on the 'complexity' of structured deposits due to early termination penalties difficult to understand. Whilst most of them substantially agreed with the proposed definition, some raised punctual objections or called for clarification.

103. A few respondents asked to clarify the non-cumulative nature of the three exceptions provided at paragraph 17 of the draft Guidelines, Annex V to the CP (one respondent proposed a rewording of the starting sentence of para 17).
104. One respondent representative of the interest of investors advised ESMA to consider other kind of fees not limited to financial ones. The respondent underlined that in some cases it is not even possible to exit early or only a couple of weeks or months after notice (in these cases the client faces large 'opportunity costs' by not being access to capital).
105. One respondent questioned whether a structured deposit that does not permit an early termination should be considered as complex.
106. It was noted that structured deposits sold in some Member States generally do not allow the client to exit a structured deposit early but only foresee specific time-frames pre-defined in the contract setting out the right to cancel without the application of an exit fee. In this scenario, while the client would generally not be charged an exit fee, he/she would be allowed to exit a structured deposit only at specific points in time.
107. It was noted that that making only structured deposits with fixed exit fees 'non-complex' might have the effect of higher exit cost to the consumer compared to other options (such as calculating the exit fee on the basis of the loss that the bank may suffer from early exit and therefore based on the price of the option of the derivative embedded within the particular deposit). Therefore, while the adopted criterion (fixed exit fee) may achieve simplicity, the fair pricing for a penalty may be lost in the process.
108. One comment received concerns the circumstance that in some jurisdictions exit fees are capped by law to the amount of the return accrued. Therefore, it was asked to clarify that if this is the case, the exit fee should not be considered complex.
109. A further comment was that the term "financial penalty" used within the CP is inconsistent with the language in MiFID II, and that "exit costs" should be the preferred terminology.

An exit penalty that is not a percentage of the original sum invested

110. One respondent asked to clarify if it should be considered as non-complex a deposit where the penalty is a percentage of the outstanding nominal amount at the moment of exit (not only a percentage of the original sum invested).
111. One respondent observed that a gradual reduction of the exit penalty over time would be considered more favourable for the client and should therefore be deemed as non-complex (as for the fixed sum).

ESMA's response

112. Regarding the non-cumulative nature of the proposed criteria, ESMA believes it is sufficiently clear that the criteria are non-cumulative and therefore does not propose to amend this further. With regards to the comment that a disclosure obligation would be more beneficial than specifying the types of exit penalty that would make a product 'non-complex', ESMA consider that mandate clearly asks for guidelines to aid the assessment of what makes it difficult for the client to understand the costs of existing before term, and therefore believes that specifying specific criteria to be appropriate in line with this mandate.
113. Some respondents commented on whether the inability to exit a structured deposit should be addressed in the guidelines. ESMA believes this issue goes beyond the mandate it has been given to determine the circumstances when the costs of exiting are difficult for the client to understand.
114. On the other hand, ESMA would like to acknowledge that clients may find difficult to distinguish between traditional deposits and structured deposits when it comes to exit costs (because they do not understand the impact of the derivative usually embedded in structured deposits).
115. ESMA notes comments that products that have variable exit costs (such as a percentage of returns accrued, or the price of the option of the embedded derivative within a particular structured deposit) will be considered 'complex'. Based on the legislative mandate, ESMA confirms the proposal included in the CP and which aimed at identifying structures making it difficult for the client to understand the cost of exiting the product before term; ESMA considers that some of the calculation methods mentioned would certainly be complex for clients to understand. On the other hand, ESMA would like to note that where the exit fee of a structured deposit is explicitly capped by law to the amount of the return accrued the structured deposit should not be deemed complex for the purpose of Article 25(4) of MiFID II.
116. ESMA agrees with comments on the use of the term "penalties" and, in line with the terminology in MiFID II, has amended the guidelines to refer to the "costs" of exiting before term.

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.

117. This question received few responses. Most of respondents expressed concerns for the negative impacts that could derive to the industry and to market participants from a non-harmonised implementation among EU due to the lack of clear criteria able to allow a correct classification of financial instruments.
118. One respondent representative of the interests of investors welcomed the benefits coming from enhancing investor protection. Another respondent representative of the interests of investors postulated that additional costs for savers and investors related to the classification of a financial instrument as complex should be considered.



119. One respondent saw a negative impact for intermediaries that should sustain excessive costs related to the classification of the complexity of each financial instrument. For this reason, the respondent considered that it would be more appropriate if the categorisation was conducted by the issuer (and mentioned in the prospectus).

120. One respondent underlined the risk of a negative impact on the domestic financial industry related to existence of a national communication on the issue of Complex products that could not be completely in line with ESMA's Guidelines.



3.5 Annex V

Guidelines on complex debt instruments and structured deposits

I. Scope

Who?

1. These guidelines apply to:
 - a. competent authorities and
 - b. firms.

What?

2. These guidelines apply in relation to Article 25(4) of Directive 2014/65/EU (MiFID II).

When?

3. These guidelines apply from 3 January 2017

II. References, abbreviations and definitions

Legislative references

<i>AIFMD</i>	Directive 2011/16/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Manager and amending Directive 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.
<i>ESMA Regulation</i>	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing an European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.
<i>MiFID</i>	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the



Council and repealing Council Directive 93/22/EEC.

MiFID II

Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast).

Abbreviations

<i>AIFM</i>	Alternative Investment Fund Manager
<i>CA</i>	Competent Authority
<i>CP</i>	Consultation Paper
<i>EC</i>	European Commission
<i>EU</i>	European Union
<i>ESMA</i>	European Securities and Markets Authority
<i>MiFID</i>	Markets in Financial Instruments Directive

Definitions

4. Unless otherwise specified, terms used in MiFID II have the same meaning in these guidelines. In addition, the following definitions apply:

<i>Firms</i>	investment firms (as defined in Article 4(1)(1) of MiFID II), credit institutions (as defined in Article 4(1)(27) of MiFID II) when providing investment services and external AIFM when providing non-core services (within the meaning of Article 6(4)(a) and (b) of the AIFMD)
<i>Debt instruments</i>	bonds, other forms of securitised debt and money market instruments.

III. Purpose

5. The purpose of these guidelines is to specify the criteria for the assessment of (i) debt instruments incorporating a structure which makes it difficult for the client to understand the risk involved and (ii) structured deposits incorporating a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term.



6. These guidelines also clarify the concept of “embedded derivatives” in order to provide an overall framework for the application of Article 25(4)(a) of MiFID II in relation to debt instruments.
7. ESMA expects these guidelines to strengthen investor protection and to promote greater convergence in the classification of “complex” or “non-complex” financial instruments or structured deposits for the purposes of the appropriateness test/execution-only business in accordance with Article 25(3) and 25(4) of MiFID II.

IV. Compliance and reporting obligations

Status of the guidelines

8. This document contains guidelines issued under Article 16 of the ESMA Regulation. In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants must make every effort to comply with the guidelines.
9. Competent authorities to whom the guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines within the document are directed primarily at financial market participants.

Reporting requirements

10. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for non-compliance, within two months of the date of publication by ESMA to complexproducts1787@esma.europa.eu. In the absence of a response by this deadline, competent authorities will be considered as non-compliant. A template for notifications is available from the ESMA website.
11. Firms to which these guidelines apply are not required to report whether they comply with these guidelines.

V. Guidelines

V.I. Debt instruments embedding a derivative

12. For the purpose of points (ii) and (iii) of Article 25(4)(a) of MiFID II, an embedded derivative should be interpreted as meaning a component of a debt instrument that causes some or all of the cash flows that otherwise would result from the instrument to be modified according to one or more defined variables.

V.II. Debt instruments incorporating a structure making it difficult for the client to understand the risk

13. For the purpose of points (ii) and (iii) of Article 25(4)(a) of MiFID II, debt instruments incorporating a structure making it difficult to understand the risk should include inter alia any of the following:

- a) Debt instruments, the return of which is dependent on the performance of a defined asset pool. This category includes debt instruments the return or performance of which depends on the receivables either fixed or revolving generated by the assets in the underlying pool.
- b) Debt instruments, the return of which is subordinated to the reimbursement of debt held by others. This category includes debt instruments structured in such a way that in the event of default by the issuer, the senior debt holders have priority access to the assets of the issuer over the subordinated holders.
- c) Debt instruments where the issuer enjoys discretion to modify the cash flows of the instrument. This category includes debt instruments structured in such a way that the anticipated revenue stream or repayment of principal is dependent on variables set by the issuer at its discretion.
- d) Debt instruments lacking a specified redemption or maturity date. This category includes debt instruments structured in such a way that there is no specified maturity date and typically therefore no re-payment of the principal amount invested.
- e) Debt instruments having an unusual or unfamiliar underlying. This category includes debt instruments structured in such a way that the anticipated revenue stream or repayment of principal is dependent on variables which are unusual or unfamiliar for the average retail investor.
- f) Debt instruments with complex mechanisms to determine or calculate the return. This category includes debt instruments structured in such a way that the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument either because certain pre-determined threshold conditions are met or because certain time-points are reached.
- g) Debt instruments structured in a way that may not provide for a full repayment of the principal amount. This category includes debt instruments presenting a structure or subject to a mechanism which, in certain circumstances, trigger a partial repayment (or no repayment) of the principal.
- h) Debt instruments issued by a special purpose vehicle (SPV) in circumstances in which the name of the debt instrument or the legal name of the SPV may mislead the investors as to the identity of the issuer or guarantor.

- i) Debt instruments with complex guarantee mechanisms. This category includes debt instruments guaranteed by a third party and structured in a way that makes it complex for the investor to assess accurately how the guarantee mechanism affects the risk exposure of the investment.
- j) Debt instruments with leverage features. This category includes debt instruments structured in such a way that the return or losses to the investor may occur at multiples to the initial investment.

V.III. Structured deposits incorporating a structure making it difficult for the client to understand the risk of return

14. For the purpose of point (v) of Article 25(4)(a) of MiFID II, a structure making it difficult for the client to understand the risk of return exists where:
- a) more than one variable affects the return received; or
 - b) the relationship between the return and relevant variable or the mechanism to determine or calculate the return is complex; or
 - c) the variable involved in the calculation of the return is unusual or unfamiliar to the average retail investor: or
 - d) the contract gives the credit institution the unilateral right to terminate the agreement before maturity.

V.IV. Structured deposits incorporating a structure making it difficult for the client to understand the cost of exiting before term

15. For the purpose of point (v) of Article 25(4)(a) of MiFID II, a structure making it difficult for the client to understand the cost of exiting the product before term exists where the exit cost is:
- a) neither a fixed sum;
 - b) nor a fixed sum for each month (or part thereof) remaining until the end of the agreed term;
 - c) nor a fixed percentage of the amount deposited.

V.V. Examples

16. The table in paragraph VI includes a non-exhaustive list of examples of debt instruments that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved and complex structured deposits for the purpose of Article 25(4)(a)(ii), (iii) and (v) of MiFID II.



VI. Table - Non exhaustive list of examples

Non-exhaustive list of examples of debt instruments that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved and complex structured deposits for the purpose of Article 25(4)(a)(ii), (iii) and (v) of MiFID II⁸

CATEGORY OF INSTRUMENT	(NON-EXHAUSTIVE) LIST OF EXAMPLES
<p align="center">DEBT INSTRUMENTS EMBEDDING A DERIVATIVE</p>	<ul style="list-style-type: none"> a) Convertible and exchangeable bonds. b) Indexed bonds and turbo certificates. c) Contingent convertible bonds. d) Callable or puttable bonds. e) Credit-linked notes. f) Warrants.
<p align="center">DEBT INSTRUMENTS INCORPORATING A STRUCTURE MAKING IT DIFFICULT FOR THE CLIENT TO UNDERSTAND THE RISK</p>	<ul style="list-style-type: none"> a) Debt instruments the return of which is dependent on the performance of a defined asset pool. Examples: Asset-backed securities and asset-backed commercial papers, Residential Mortgage Backed Securities (RMBS), Commercial Mortgage Backed Securities (CMBS), Collateralised Debt Obligations (CDOs) b) Debt instruments the return of which is subordinated to the reimbursement of debt held by others. Examples: <ul style="list-style-type: none"> - subordinated debt instruments; - certificates (as defined under Article 2(1)(27) of MiFIR). c) Debt instruments where the issuer enjoys discretion to

⁸ In some cases specific "types" of debt instruments have been identified, in other case a specific description has been provided. In some cases a financial instrument could fall into more than one category.

	<p>modify the cash flows of the instruments.</p> <p>d) Debt instruments lacking a specified redemption or maturity date. Examples:</p> <ul style="list-style-type: none"> - perpetual bonds. <p>e) Debts instruments having an unusual or unfamiliar underlying. Examples:</p> <ul style="list-style-type: none"> - Debt instruments referencing underlying such as non-public benchmarks, synthetic indices, niche markets, highly technical measures (including price volatility and combinations of variables); - catastrophe bonds. <p>f) Debt instruments with complex mechanisms to determine or calculate the return. Examples:</p> <ul style="list-style-type: none"> - debt instruments structured in such a way that the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument either because certain pre-determined threshold conditions are met or because certain time-points are reached. <p>g) Debt instruments structured in a way that may not provide for a full repayment of the principal amount:</p> <ul style="list-style-type: none"> - debt instruments eligible for bail-in tool purpose. <p>h) Debt instruments issued by a special purpose vehicle (SPV) in circumstances in which the name of the debt instrument or the legal name of the SPV may mislead the investors as to the identity of the issuer or guarantor:</p> <p>i) Debt instruments with complex guarantee mechanisms. Examples:</p> <ul style="list-style-type: none"> - Debt instruments with a guarantee mechanism where the trigger for the guarantee depends upon one or several conditions in addition to the default of the issuer; - Debt instruments with a guarantee mechanism where the level of guarantee or the actual trigger of the
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	<p>guarantee are subject to time limitations.</p> <p>j) Debt instruments with leverage features</p>
<p style="text-align: center;">STRUCTURED DEPOSITS INCORPORATING A STRUCTURE MAKING IT DIFFICULT FOR THE CLIENT TO UNDERSTAND THE RISK OF RETURN</p>	<p>Structured deposits, in cases where:</p> <p>a) More than one variable affects the return received. Examples:</p> <ul style="list-style-type: none"> - Structured deposits where a basket of instruments or assets have to outperform a specified benchmark for a return to be paid; - Structured deposits where the return is determined by the combination of two or more indices. <p>b) The relationship between the return and relevant variable or the mechanism to determine or calculate the return is complex. Examples:</p> <ul style="list-style-type: none"> - structured deposits structured in a way that the mechanism under which the price level of an index is reflected in the return involves different market data points (i.e. one or more thresholds have to be met), or several index measurements at different dates; - structured deposits structured in a way that the capital gain or interest payable step up or down in certain specific circumstances; - structured deposits structured in a way that the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument. <p>c) The variable involved in the calculation of the return is unfamiliar or unusual to the average retail investor. Examples:</p> <ul style="list-style-type: none"> - Structured deposits where the return is linked to a niche market, an in-house index or other non-public benchmark, a synthetic index, or a highly technical measure such as asset price volatility. <p>d) The contract gives the credit institutions the unilateral right to terminate the agreement before maturity</p>

<p style="text-align: center;">STRUCTURED DEPOSITS INCORPORATING A STRUCTURE MAKING IT DIFFICULT FOR THE CLIENT TO UNDERSTAND THE COST OF EXITING BEFORE TERM</p>	<p>Structured deposits, in cases where:</p> <ul style="list-style-type: none"> a) An exit fee is not a fixed sum. Examples: <ul style="list-style-type: none"> - structured deposits having a variable or “capped” exit fee (i.e. a fee up to 300 euros is charged in case of early exit); - structured deposits referring a variable factor such as an interest rate for the calculation of the exit fee. b) An exit fee is not a fixed sum for each month remaining until the agreed term. Examples: <ul style="list-style-type: none"> - structured deposits having a variable or capped exit fee per month remaining until the agreed term (i.e. a fee up to 50 euro per month in case of early exit). c) An exit fee is not a percentage of the original sum invested. Examples: <ul style="list-style-type: none"> - structured deposits having an exit fee that is at least equal to the amount of the returns accrued until the early exit date.
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