COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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FEEDBACK STATEMENT

MiFID complex and non complex financial instruments for the purposes of the Directive's appropriateness requirements

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I Executive Summary

CESR has sought in this Feedback Statement (FS) to respond to comments made and points raised in response to its consultation paper (CP) "MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements" (Ref. CESR/09-295). The consultation paper was published on 14 May 2009. This FS covers the same areas as the CP. CESR's final policy position is published in a set of Q&As (Ref. CESR/09-559).

This Feedback Statement sets out CESR's response to the issues respondents raised, particularly regarding the implications of the appropriateness requirements for:

- types of shares and the categorisation of subscription/nil paid rights;
- money market instruments, bonds and other forms of securitised debt, including the treatment of money market instruments, asset backed securities, bonds and other forms of securitised debt. Also considered is CESR's response to issues raised on instruments that embed a derivative, callable and puttable bonds, covered bonds and depositary receipts among others;
- the treatment of units in collective investment undertakings (including non-UCITS[1];) for the purposes of the appropriateness requirements;and
- certain other products such as ETCs.

It also clarifies the interpretation of the criteria set out under Art. 38 of the MiFID Level 2 Directive. This includes such issues as the interpretation of frequent opportunities to dispose or redeem an instrument, liquidity and also when comprehensive information can be considered to be publicly available.

CESR stresses that its analysis, and the range of products considered, does not aim to be exhaustive, given the number and variety of types of MiFID products traded in the world's financial markets. Its focus is financial products that are (or can be) transacted by retail clients. The central aim of the MiFID appropriateness test is to prevent complex products from being sold on an 'execution-only' basis to retail clients who do not have the experience and/or knowledge to understand the risks of such products.

[1] UCITS stands for Undertakings for Collective Investments in Transferable Securities.

II Overview

1. On 14 May 2009, CESR published a consultation paper (CP) entitled "MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements" (Ref. CESR/09-295) In that CP, CESR set out for consultation its analysis of a range of MiFID financial instruments and its proposed views on how specific types of MiFID products are likely to fit within the complex/non-complex categories for the purposes of the appropriateness requirements[2].

2. CESR noted that its analysis, and the range of products considered, did not aim to be exhaustive, given the number and variety of types of MiFID products traded in the world's financial markets. Its focus was financial products that are (or can be) transacted by retail clients. The central aim of the MiFID appropriateness test is to prevent complex products from being sold on an 'execution-only' basis to retail clients who do not have the experience and/or knowledge to understand the risks of such products. The MiFID Level 2 Directive allows a firm to assume that a professional client has the necessary experience and knowledge in order to understand the risks involved in relation to those investment services or types of transactions or products for which the client is classified as a professional client.[3]

3. Overall, the intended outcomes of CESR's exercise received broad support. However, respondents raised issues and questions about the rationale for classification of certain types of financial instruments as complex or non-complex. Some respondents also raised questions about whether MiFID's factors for assessment were always correct. Some wider questions were also raised about the possible future implications of EU work on "packaged retail investment products" and the directive on alternative investment fund managers for the MiFID appropriateness requirements.

4. CESR has sought to respond to these points in this Feedback Statement and has set out its final policy approach in a set of Q&As on this topic (Ref. CESR/09-559).

5. CESR also reiterates the point it made in paragraphs 11 and 12 of the CP 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. As CESR noted, MiFID requires that firms should provide 'appropriate information' in a 'comprehensible form' about any MiFID 'financial instruments and proposed investment strategies'; including 'appropriate guidance on and warnings of risks associated with investments in those instruments or in respect of particular investment strategies', so 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'. Communications to clients should also be clear, fair and not misleading. In addition, MiFID requires an investment firm to act honestly, fairly and professionally in accordance with the best interests of its clients. As one respondent pointed out, MiFID also contains provisions designed to address conflicts of interests and inducements, which are also relevant to non-advised intermediation and distribution by MiFID firms.

6. The consultation period closed on 17 July 2009. CESR received 34 responses. CESR is grateful to all the respondents for taking time to give CESR their views. A list of all non-confidential responses can be found in Annex 1.

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[2] This paper will make references to two MiFID Directives: the Level 1 Directive 2004/39/EC and the Level 2 Directive 2006/73/EC. The appropriateness requirements are set out in Art. 19(5) of the MiFID Level 1 Directive and Art. 36 and 37 of the MiFID Level 2 Directive. The prescribed exceptions to the 'appropriateness test' are set out in Art. 19(6) of the MiFID Level 1 Directive and Art. 38 of the MiFID Level 2 Directive.

[3] As one respondent pointed out, firms are free to apply the appropriateness test more widely than is mandatory, if they so wish; whether to instruments or clients.

III Section 1 – Shares

7. In this section of the CP, CESR noted that under Art. 19(6) of the MiFID Level 1 Directive, shares admitted to trading on a regulated market or in an equivalent third country market are to be treated as 'non-complex' financial instruments for the purposes of the appropriateness requirements. Any other types of shares that are not expressly mentioned in Art. 19(6) will have to be assessed as per the criteria for "other non-complex financial instruments" set out in Art. 38 of the MiFID Level 2 Directive (hereafter referred to as 'the Art. 38 criteria').

What types of shares are specifically covered under Art.19(6) as being non-complex?

8. CESR suggested that the answer to the above question is not as straightforward as it might first appear. CESR set out two key considerations:
   - firstly, MiFID does not define the term 'shares', either for the purpose of Art. 19(6) or elsewhere, and this element of company law is not harmonised at EU level; and
   - secondly, the definition of transferable securities in MiFID Level 1 Art. 4(1)(18)(a) makes a distinction between 'shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares'.

9. CESR suggested that the reference to shares in MiFID Art. 19(6) could therefore be interpreted as capturing shares in companies where those shares are admitted to trading on a regulated or an equivalent third country market. This reading would exclude other securities equivalent to shares in companies, partnerships or other entities, as well as depositary receipts in respect of shares, with this group of securities having to be assessed against the Art. 38 criteria instead of being automatically non-complex.

10. In the CP, CESR asked the following question:

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?

11. While some respondents agreed with CESR's view, others did not. Respondents who did not agree with CESR's view thought that all shares traded on regulated markets should automatically be considered to be non-complex, regardless of their type. They took the view that Art. 19(6) should not be understood as excluding other types of securities representing capital of companies.

12. Some respondents pointed out that shares can be traded on a range of markets and venues, including regulated markets, non-regulated markets and Multilateral Trading Facilities (MTF). They were concerned that this could give rise to a situation where the same share is considered as automatically non-complex if traded on a regulated market but not when traded on an MTF or an exchange that is not a regulated market. Therefore, they felt that the distinction as to whether a share is complex or non-complex is more to do with the nature of the share than the market it is traded on. A similar point was made by another respondent who commented that the question of whether a share is complex or non-complex should be decided in the light of the quality and nature of the share rather than on the basis of the venue on which trading takes place.

13. There was a suggestion by more than one respondent that Art. 19(6) be amended (or Level 3 guidance provided) to cover shares admitted only to trading on at least some MTFs or non-regulated markets (such as the Alternative Investment Markets operated by the London Stock Exchange and Borsa Italiana). It was argued that most such markets benefited from a

robust regulatory framework with ongoing disclosure (in some cases including provisions of the Transparency Directive), which should ensure the integrity of the companies on the market. Therefore, it was argued that such shares should be deemed non-complex because there is nothing inherently more complex about such a share than a share admitted to trading on a regulated market. It was suggested that such shares could be expected to consistently meet each of the four of the Art. 38 criteria and should therefore be considered as automatically non-complex.

CESR's response

For CESR's response on how specific types of share might be covered by Art. 19(6), please see the responses to Questions 2-8.

CESR acknowledges the view that the distinction as to whether a share is automatically non-complex or has to be assessed against the Art. 38 criteria generally has more to do with the nature of the share than whether it is traded on a regulated market, MTF or other venue.

It is important to note that where a share is admitted to trading on a regulated market (or equivalent third country market), it is automatically non-complex, no matter where else it may be traded.

However, shares admitted to trading on regulated markets generally face stricter listing and/or admission requirements than those admitted to trading on MTFs and other trading platforms. There may also be differences in the liquidity of trading on some non-regulated markets. This distinction can justify a differentiated regulatory treatment for the purposes of the appropriateness requirements where a share is only traded in a venue other than a regulated market.

CESR therefore agrees that some ordinary shares only admitted to trading on an MTF operated by a market operator should inherently be no more complex than a share admitted to trading on a regulated market. Where this is so, the criteria in Art. 38 should readily be satisfied, meaning that the instrument can be treated as non-complex even where it is not automatically so.

However, in some cases, CESR believes that the trading of certain shares on non-regulated markets would not allow the instruments to fulfil all of the Art. 38 criteria; particularly perhaps the criterion that requires frequent opportunities to dispose of, redeem or realise that instrument at prices that are publicly available to market participants and that are either market prices or prices made available, or validated, by valuation systems independent of the issuer.

The current wording of MiFID Art. 19(6) would need to be amended to allow shares admitted to trading on an MTF to be treated as automatically non-complex. This could be considered further during the future MiFID review, though CESR believes that assessment against the Art. 38 criteria should deliver reasonable outcomes.

14. CESR also discussed two other particular issues in the Shares section of the CP.

15. The first was that a case could be made that shares in a non-UCITS collective investment undertaking that takes the legal form of a corporate body should also be treated as automatically non-complex, if those shares are admitted to trading on a regulated market (or equivalent third country market). On this issue, CESR took the view that, for present purposes, shares in such non-UCITS undertakings should be assessed against the Art. 38 criteria, in the same way as units in non-UCITS open-ended and closed-ended undertakings.

16. The second issue was that CESR is aware that some differences remain between Member States as to the definition and precise specifications of preference shares or preferred stock in companies and, therefore, whether they should be treated as equity or debt.

17. CESR asked the following questions:

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

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

18. With regard to question 2, while some respondents agreed with CESR that shares in a non-UCITS undertaking should be assessed against the criteria in Art. 38, others did not. Numbers were similar on each side of the debate. One respondent believed that shares in non-UCITS should be assessed the same way as any other shares; for example, if they are traded on an EEA regulated market, they are automatically non-complex. Another respondent argued that this was what the agreed text of MiFID required, as it stands.

19. Regarding preference shares and convertible preference shares, again views were mixed. One respondent thought preference shares and preferred stock should be assessed against the Art. 38 criteria. Other respondents took the view that preference shares should be treated as automatically non-complex, alongside other shares. However, most respondents seemed to accept that convertible preference shares do contain a greater element of complexity and should therefore be considered as complex for the purposes of appropriateness.

20. Regarding question 3 above, respondents did not have any other comments on the CP's discussion of shares under Art. 19(6). One respondent reiterated the point that the nature of the financial instrument rather than the trading venue should take priority in determining the appropriateness requirements.

CESR's response

CESR has considered the response to these two questions. CESR is still of the opinion that shares in a non-UCITS undertaking are first and foremost investments in a collective investment undertaking and that (for the purposes of the appropriateness requirements) this should prevail over the legal form they take (whether units or shares) in the interests of a consistent regulatory treatment of such investments for the purposes of the appropriateness requirements. CESR believes that shares in a non-UCITS undertaking should therefore be assessed against the Art. 38 criteria, unless the final Directive on Alternative Investment Fund Managers (AIFMD) prescribes a different treatment.

CESR has also considered the responses regarding preference shares and convertible preference shares. CESR's view is that preference shares that do not embed a derivative should be considered as automatically non-complex for these purposes provided they are admitted to trading on a regulated market. Preference shares that embed a derivative should be considered as complex (for convertible preference shares, please also see CESR's response to question 5).

How should other types of equity securities be treated?

21. In the CP, CESR proposed that all other types of equity securities that are not expressly mentioned in Art. 19(6) of the MiFID Level 1 Directive would have to be assessed against the Art. 38 criteria. This includes shares not admitted to trading on a regulated market or an equivalent third country market, depositary receipts for shares, and 'stapled' securities that comprise different types of security (one of which is a share).

22. CESR asked the following question;

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

23. Some respondents agreed with CESR that these other equity securities should be assessed against the Art. 38 criteria, while other respondents disagreed on one or more of the securities mentioned in the CP.

24. A number of respondents did not share CESR's conclusion on depositary receipts, arguing that the instrument traded in reality is the share, even if the share from both a holding and clearing and settlement perspective is handled via the depositary receipt. One respondent stated that it could well be that a share itself is listed and traded in one EU regulated market but is listed/traded as a depositary receipt on another regulated market.

25. Some respondents took the view that whether or not a depositary receipt is considered complex or not depends on the nature of the underlying security. If the underlying security is non-complex then the depositary receipt should be non-complex, and vice versa.

26. Regarding 'securities equivalent to shares in companies, partnerships or other entities and depositary receipts in respect of shares', one respondent thought that given the vagueness of these products and the possible variations, they should be assessed against the Art. 38 criteria.

27. As a general point, a number of respondents argued that the list of securities included in CESR's proposed table of complex and non-complex instruments should be considered open, as a non-exhaustive list of examples, so that other instruments may be included in the future.

CESR's response

As most respondents agree with CESR's view on these securities, with the exception of depositary receipts, CESR will only address this particular instrument in its response.

As CESR stated in the CP, MiFID's definition of transferable securities distinguishes depositary receipts in respect of shares (and bonds) from the shares (and bond) themselves. This suggests that under the Directive depositary receipts admitted to trading on a regulated market are not identical to shares (and bonds) and therefore not automatically non-complex for the purposes of appropriateness. CESR notes that depositary receipts are listed, traded and settled independently of the underlying share. CESR's view therefore remains that, under MiFID as drafted, depository receipts in respect of shares should be assessed against the Art. 38 criteria.

Regarding the point that the list of securities should be regarded as open, CESR agrees. As it stated in the CP, the analysis and range of products considered cannot possibly be regarded as exhaustive or complete, given the number and variety of types of MiFID products traded in the world's financial markets. The examples given are not an exhaustive list.

Do convertible shares fulfil the Art. 38 criteria for being non-complex?

28. In the CP, CESR stated that it believed that convertible shares (i.e. convertible preference shares or convertible preferred stock) would fall within the type of transferable securities described in Art. 4(1)(18)(c) of MiFID Level 1 Directive as 'other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by a reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures'. The types of securities covered by Art. 4(1)(18)(c) are expressly excluded from eligibility as 'other non-complex instruments' under the Art. 38 criteria. This means that convertible shares should be treated as complex instruments for the purposes of the appropriateness requirements. This would be logically consistent with CESR's view of the Directive's treatment of convertible bonds.

29. CESR asked the following question:

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

30. While some respondents agreed with CESR that convertible shares will always be complex under the appropriateness requirements, others did not.

31. One respondent stated that in its opinion, convertible shares should be classified as 'other securities equivalent to shares in companies' under Art. 4(1)(18)(a) of the MiFID Level 1 Directive and assessed against the Art. 38 criteria. The respondent also suggested that if the prospectus defines a security as non-complex, the supervisor may express an opinion on this issue during the vetting of the prospectus and determine whether it should be classified differently in the retail placement phase.

32. Another respondent disagreed with CESR's reasoning that convertible shares can be viewed as involving an 'option', so making them complex.

CESR's response

CESR continues to believe that convertible shares fall within the type of transferable securities described in Art. (4)(1)(18)(c) of the MiFID Level 1 Directive as 'other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures'. This group of securities are expressly excluded from eligibility as 'other non-complex financial instruments' under the Art. 38 criteria. Therefore, convertible shares should be treated as complex products for the purposes of the appropriateness test.

CESR does not agree that convertible shares should be classified as 'other securities equivalent to shares in companies' under Art. 4(1)(18)(a) of the MiFID Level 1 Directive.

Do subscription rights/nil paid rights fulfil the Art. 38 criteria for being non-complex?

33. CESR expressed the view in the CP that subscription rights/nil paid rights could fall within the type of transferable securities described in Art. 4(1)(18)(c) of MiFID Level 1 Directive as 'other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures'. This would mean that (since securities covered by Art. 4(1)(18)(c) are expressly excluded from eligibility as 'other non-complex financial instruments'), subscription rights/nil paid rights would need to be treated as complex products for the purposes of the appropriateness test.

34. However, CESR noted that such a classification of subscription rights/nil paid rights as complex products may cause some practical issues. CESR noted that it might not be in the interests of the shareholders, given the short response time frame in which they may need to make an investment decision regarding the rights. Such a classification might risk slowing down or obstructing shareholders' responses, and may also be disproportionate where the shareholder has received the rights free of charge and without obligation. CESR also noted that it might be possible to analyse the rights, not as a separate security, but as a component of the share itself that is separated from the share only to facilitate the taking up and trading of the rights. This could allow the treatment of the rights relating to a share that is admitted to trading on a regulated market (or equivalent third country market) in the same way as the share itself.

35. CESR asked the following questions:

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

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?

36. Regarding question 6, nearly all respondents to this question disagreed that subscription rights/nil-paid rights should be treated as complex products for the purposes of the appropriateness requirements, mainly for the reasons CESR had outlined in the CP and restated above. Respondents also agreed with CESR's analysis of the reasons why classifying subscription rights/nil-paid right as complex could prove problematic.

37. However, one respondent stated that these types of rights should be classified as complex because their markets are usually in the hands of a few professional traders, can be very volatile, are open for only a short period, and are not transparent for the retail investor. This respondent also argued that broker fees can deter a retail investor from trading a small amount of the rights and that they therefore bear a specific trading risk, in addition to the fact that they are not in the category of ordinary shares.

38. Some respondents saw some inconsistency in an outcome whereby the sale of rights would be subject to the appropriateness test (as a complex instrument), whereas when the shareholder acquired the shares to which such rights were attached this transaction was not subject to the test (and nor would any subsequent sale of such shares).

39. One respondent suggested that the only transaction that might be distinguished is where a client wanted to exercise rights to buy (complex) rather than to sell (non-complex).

40. Another respondent suggested that if CESR does not consider these instruments to be non-complex, it should consider a simplified appropriateness test for them.

41. Respondents to question 7 did not have any further substantive comments.

42. Most respondents to question 8 considered the list sufficient. One respondent was of the view that there should be no common list at this point in time. Another suggested that the French 'ABSA' instruments ("action à bon de souscription d'actions"; shares with share warrants attached) should be considered as complex for the purposes of the appropriateness test.

43. Although the question is not restricted to equity warrants, one group of respondents asked CESR to recognise the distinction between warrants that a retail client actively chooses to invest in and those that the retail client acquires by default. The respondents' view is that where the retail client purchases a warrant or covered warrant then under these circumstances the firm should perform an appropriateness test to ensure the client has understood the ramifications of his actions. However, where a retail client has acquired a warrant by default and simply chooses to sell the asset and realise the holding, then there is little to be gained by undertaking an appropriateness test as this would be disproportionate.

CESR's response

Regarding subscription rights/nil-paid rights, the starting point is that they fall within the type of transferable securities described in Art. 4(1)(18)(c) of MiFID Level 1 Directive, as 'other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement

determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures'. Since securities covered by Art. 4(1).(18)(c) are expressly excluded from eligibility as "other non-complex financial instruments" under the Art. 38 criteria, this means that subscription rights/nil-paid rights should be treated as complex products for the purposes of the appropriateness test.

However, CESR agrees with respondents that for the purposes of the exercise and sale of these rights by shareholders to whom they have been granted, they should not be seen as financial instruments in themselves. They should be considered as a component of the share itself (the right is separated from the share only to facilitate the trading of the rights). It would be reasonable therefore for these rights to be categorised in the same way as the share itself, but only where the instrument that they give rights to subscribe for is the same financial instrument that gave rise to the subscription right. This interpretation could also cover the strictly necessary acquisition in the secondary market of subscription rights to round up the numbers of rights necessary to acquire the relevant share.

Where the exercise of the subscription rights involves the purchase of financial instruments which are different to the shares which gave rise to the subscription rights, then the exercise of such subscription rights should be regarded as complex or non-complex depending on the classification of the financial instrument being offered for purchase.

CESR therefore concludes that if the type of share itself is non-complex, the primary market acquisition and exercise of subscription rights/nil paid rights (including the strictly necessary acquisitions in the secondary market of subscription rights to round up the numbers) should also be classified as non-complex for the purposes of the appropriateness test. If, on the other hand, the share is classified as complex, then the primary market acquisition and exercise of subscription rights/nil paid rights should also be classified as complex for the purposes of the appropriateness test.

For the purposes of secondary market acquisitions of subscription rights, these instruments ought to be classified as falling within Art. 4(1)(18)(c) of MiFID Level 1 Directive, and therefore are complex products for the purposes of the appropriateness test.

Secondary market disposals of subscription rights by shareholders to whom these instruments have been granted can be regarded as necessary actions to obtain monies equivalent to dividends. Therefore the application of the appropriateness test to such transactions would be unnecessary in these circumstances.
CESR is aware of the legal challenges that the above policy poses, and urges the European Commission to introduce this point in the forthcoming MiFID review so that the above policy is set on solid legal grounds.

As previously stated, it is not CESR's intention to provide an exhaustive and complete list of financial instruments. However, CESR members are content to include ABSAs as another example of instruments that should be assessed against the Art. 38 criteria. Since the BSA will fall under Art. 4(1)(18)(c) of MiFID, the ABSA should be considered as complex.

On the point about warrants and covered warrants, since these instruments will fall within the scope of Art. 4(1)(18)(c) of the MiFID Level 1 Directive, under the Art. 38 criteria these instruments cannot be treated as non-complex. MiFID therefore provides no flexibility for such instruments to be treated differently according to whether a retail client actively chooses to invest or 'acquires by default', if transactions are undertaken on a non-advised basis.

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

44. In the CP, CESR explained that Art. 19(6) of the MiFID Level 1 Directive suggests that money market instruments, bonds and other forms of securitised debt are non-complex instruments for the purposes of the appropriateness requirements, unless they embed a derivative. CESR stated that it sees the derivative consideration applying to all of these instruments since they are all forms of securitised debt.

45. The CP also considered the coverage of money market instruments, Treasury bills, certificates of deposits and commercial paperas well as types of instrument that might be regarded as embedding a derivative (and therefore complex for the purposes of the appropriateness requirements).

46. CESR asked the following questions:

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

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?

47. Regarding question 9, while some respondents agreed with CESR's view on the treatment of money market instruments, others did not.

48. One respondent who did not agree with CESR's view stated that it is not the intrinsic features of money market instruments that make them complex for appropriateness purposes, but the fact that they may be traded on non-transparent, unregulated markets with little access for the retail investor. The respondent suggested that since these markets have been unable to provide acceptable minimum liquidity in the last two years, that retail investors should not be exposed to these instruments without advice or the appropriateness test. The respondent argued that these markets should become more transparent and accessible before the instruments traded are treated as non-complex for the purpose of the appropriateness requirements.

49. Another respondent disagreed that instruments that embed a derivative should be regarded as complex. The respondent feared that every treasury instrument could fall into the complex category. On this same point, another respondent thought that classifying all products that embed a derivative as complex would lead to a situation where products issued as securities are treated differently from financial instruments with similar risk profiles and structures but a different legal form.

50. Respondents to question 10 did not have any further comments.

CESR's response

CESR has the following comments on the responses to question 9.

CESR acknowledges that money market liquidity has suffered in the last two years. CESR also acknowledges that there is limited trading in some money market instruments, even without the effects of recent market conditions. However, Art. 19(6) of the MiFID Level 1 Directive is clear that money market instruments can be sold without an investment firm conducting an assessment of appropriateness under Art. 19(5). Money market instruments that do not embed a derivative and whose structure does not make it difficult for the investor to understand the risk attached to the product should be considered as non-complex.

Regarding instruments that embed a derivative, CESR's reading of MiFID remains that such instruments are to be treated as complex for the purposes of the appropriateness requirements. CESR believes that this reading is consistent with the European Commission's Background Note of February 2006, quoted in the CP (including the statement that '…derivatives are assumed to be complex because their value is derived from another financial instrument or asset, adding a level of complexity to the understanding of the characteristics and valuation of those instruments').

Which types of instruments are included in this category as bonds and other forms of securitised debt?

51. In the CP, CESR made a distinction between traditional bonds, which in CESR's view are the bonds referred to in Art. 19(6) of the MiFID Level 1 Directive, and 'other forms of securitised debt'.

Does this mean that all debt securities (bonds, money market instruments and other debt securities) are non-complex financial instruments?

52. CESR explained that it rejects the interpretation of MiFID that reads the term 'other forms of securitised debt' as meaning only debt that has undergone a securitisation process.

53. CESR also set out its view that a number of types of securitised debt structures cannot accurately be described as 'non-complex'. Asset Backed Securities, for example, should not be regarded as automatically non-complex for the purposes of Art. 19(6) and should not be transacted for retail clients on a non-advised basis without an appropriateness assessment. CESR acknowledged, however, that most retail clients will not be investing directly in most types of Asset Backed Securities, and certainly not without the benefit of investment advice.

54. CESR asked the following questions:

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

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

55. Although some respondents agreed that bonds and other asset backed securities fall within the category of 'other forms of securitised debt' in Art. 19(6), most respondents to question 11 did not agree with CESR that all asset backed securities should necessarily be regarded as complex instruments for the purposes of the appropriateness test.

56. One respondent argued that it is more appropriate that 'structured products' be assessed against the Art. 38 criteria, instead of considering all forms of 'securitised debt' as being automatically complex. This respondent also argued that structured products have degrees of complexity and that some are in fact quite easy to understand. The respondent questioned whether CESR's interpretation was consistent with MiFID as it stands, and suggested that the point should be addressed in the upcoming review of MiFID.

57. Other responses to question 12 varied. One respondent felt that no clarification was required. Another respondent stated that further clarification is not required but that each structured product should be assessed against the Art. 38 criteria. Some respondents agreed in principle that MiFID could usefully be clarified. However, one respondent believed that the clarification could involve reconsideration of the efficiency and transparency of non-equity markets (especially the bond markets), which the respondent felt that MiFID had not fully reflected.

58. Another respondent pointed out that the instruments in question are not normally marketed to retail clients nowadays.

CESR's response

Regarding the responses to questions 11 and 12, CESR agrees (as it noted in its CP) that there are different types of instruments that could fall under the category of 'other forms of securitised debt' and accepts that some of these instruments may in fact be easier to understand than others.

However, CESR's view is that not all instruments that could fall into the 'other forms of securitised debt' category should be classified as non-complex for these purposes.

CESR has reviewed the other points made by respondents. CESR's view is that there will be a number of these instruments, such as some asset-backed securities, that will be complex products because they embed a derivative. There will also be a number of these instruments that will be complex products because the level of complexity of their structure will affect the ease with which the risks attached to the product are understood. There is a third group of products for which CESR is prepared to revise its position in the CP to state that products considered as 'other forms of securitised debt' such as some structured products, should be assessed against the criteria in Art. 38 of the MiFID Level 2 Directive. However, during the consultation, no such instrument has been put forward to CESR as an instrument that would meet the tests in Art. 38 of the MiFID Level 2 Directive and would be categorised as non-complex.

CESR is of the opinion that the European Commission should consider the treatment of fixed income products in its forthcoming MiFID review.

59. CESR also asked the following questions in this section:

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)?

Question 14: Do you have any other comments on MiFID's treatment of 'other forms of securitised debt' for the purpose of the appropriateness requirements?

60. There were few additional comments on these two questions. However, one respondent questioned whether even ordinary bonds and Medium Term Notes should be considered as non-complex instruments, given the respondent's view of market conditions and the liquidity of these markets in 2008 and 2009, and the levels of transparency in those markets.

Is there a definition for bonds and other forms of securitised debt that embed a derivative?

61. As explained in the CP, MiFID does not include a definition of bonds and other forms of securitised debt that embed a derivative, either at Level 1 or level 2. However, the concept of an instrument 'embedding a derivative' is increasingly being used and discussed in a range of contexts, including by those bodies involved in the development and setting of appropriate accounting standards.

What types of instruments are included in this category?

62. In this section CESR gave examples of money market instruments, bonds and other forms of securitised debt that could be regarded as embedding a derivative.

63. CESR asked the following question:

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)?

64. While some respondents to this question agreed that instruments that embed a derivative should be considered as complex under MiFID, as the Directive suggests, a number of other

respondents disagreed, or objected to specific types of instrument being included in the list. A group of respondents with particular academic backgrounds challenged MiFID's position that instruments embedding a derivative should always inherently be regarded as complex. This group suggested that the determining factor should be whether the presence of derivatives created or increased risks.

65. Of the examples proposed in the CP, some respondents thought that structured deposits whose initial capital is fully guaranteed should be excluded, as they are strictly banking products that do not fall within the scope of MiFID. This is also the position in the European Commission's MiFID O&A in response to questions 118 and 203.

66. One respondent disagreed with the inclusion in the list of convertible and exchangeable bonds. This respondent disagreed with CESR's view that they can be regarded as bonds embedding a derivative and therefore ineligible to be regarded as non-complex instruments. The respondent believes that such instruments should be regarded as non-complex instruments by their nature, or at least to be assessed against the Art. 38 criteria. Another respondent argued that these instruments were complex but suggested some improvements to CESR's characterisation of them.

67. Another respondent disagreed with CESR's reading of Art. 19(6) of MiFID Level 1 Directive that instruments that do not meet the criteria of that Art. should automatically be considered complex. The respondent argued that instruments that are not automatically non-complex should be assessed individually against the Art. 38 criteria. Another respondent said that CESR's interpretation that instruments that embed a derivative should be considered as complex would lead to a situation where products issued as securities are treated differently from financial instruments with similar risk profiles and structures, but a different legal form.

68. However, several other respondents argued strongly that instruments that either 'explicitly' or 'implicitly' embed a derivative (including credit derivatives) should be treated as complex.

CESR's response

CESR would like to clarify that it agrees with the European Commission's position on structured deposits. Deposits are banking products that do not fall within the scope of MiFID. The Commission identified only one type of structured deposit covered by MiFID (see CESR's feedback on Section 5 of the CP, later). CESR's intention was to confirm this point in order to pre-empt any further questions.

Regarding convertible and exchangeable bonds, CESR does not agree that they do not embed a derivative. They contain the possibility of conversion into stock, whether that of the issuer or a company other than the issuer. CESR therefore considers that these instruments should automatically be considered as complex for the purposes of the appropriateness requirements because they embed a derivative. Paragraph 53 of the CP elaborates on how CESR formulated its view on the concept of an embedded derivative (including taking account of IAS 39 and consistent previous CESR advice).

CESR reiterates its position in the CP that money market instruments, bonds and other forms of securitised debt that embed a derivative should not be categorised as non-complex for the purposes of the appropriateness test. If an instrument is explicitly excluded from the list of non-complex instruments in Art. 19(6) of MiFID Level 1 Directive, it should not be brought back in via Art. 38 of the MiFID Level 2 Directive.

CESR disagrees that MiFID only defines those instruments that would be considered as non-complex and does not allow types of 'automatically' complex instrument to be deduced. For example, instruments within the scope of the first subparagraph of the Art. 38 criteria will always be complex instruments.

Are callable and puttable bonds non-complex or complex financial instruments for the purposes of the appropriateness test?

69. CESR recognised in the CP that it is reasonable to regard callable and puttable bonds as bonds embedding a call or put option, with the price of the bond taking these components into account. This would mean that such bonds could not be regarded as non-complex for the purposes of the appropriateness requirements.

70. CESR asked the following question:

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?

71. Most respondents to this question did not agree with CESR that callable and puttable bonds should be treated as complex financial instruments for the purposes of the appropriateness test. However, CESR received arguments from some academic respondents explaining why volatility risks would make these instruments complex.

72. However, some respondents challenged the view that the specific features of such bonds make them so complicated as to classify them as complex financial instruments. Moreover, one respondent stated that entities are obliged to provide clients with sufficient information to enable them to understand the peculiar features of the instrument they are going to acquire. These respondents preferred that the instruments be assessed against the Art. 38 criteria to determine whether they are non-complex.

73. Some other respondents questioned whether such bonds embed a derivative (an option), though one acknowledged that at least some of these instruments may be difficult for retail investors to understand.

CESR's response

CESR is not persuaded by arguments that these instruments should be treated as automatically non-complex for the purposes of the appropriateness test. In developing its CP, CESR considered whether or not such instruments could reasonably be regarded as embedding a derivative (making them complex) or whether they could be assessed against the Art. 38 criteria. It concluded that the instruments could be regarded as embedding an option for these purposes, and that it was therefore reasonable for a firm to be required to carry out an appropriateness test to determine whether a retail client had the knowledge/experience to understand the risks involved.

What is the treatment of Spanish participaciones preferentes?

74. In the CP, CESR stated that *participaciones preferentes* should be treated as complex instruments for the purposes of the appropriateness requirements.

What is the categorisation of covered bonds?

75. In the CP, CESR differentiated between traditional covered bonds (which it considered to be non-complex) and structured covered bonds (which it considered should be treated in the same way as Asset Backed Securities). CESR also stated that mortgage bonds issued by a credit institution under the conditions stated by Art. 5(4)(b) of the Prospectus Directive should be considered to be non-complex instruments.

76. CESR asked the following question:

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

77. While some respondents agreed with CESR's distinction, others did not. Numbers were similar on each side.

78. One respondent stated that on- and off-balance sheet forms of these types of bonds constitute a difference in legal form only, not in substance, and that this criterion has no bearing on the inherent complexity of one or the other framework. This respondent also suggested that compliance with UCITS Art. 22(4) – which has the advantage of being an existing legislative definition – would be the most appropriate criteria to distinguish between different covered bonds frameworks.

79. Another respondent, while agreeing with CESR's distinction, felt that the requirements of the Prospectus Directive may not be user-friendly for retail clients and not clear enough on these kinds of risks. Another respondent thought that CESR has relied on perceived risks rather than the inherent complexity of the structure.

80. Regarding Spanish 'participaciones preferentes', respondents to this question thought this should not have been dealt with under the bonds section as they are essentially preference shares. One respondent stated that these instruments should normally be classified as non-complex but given their accounting treatment they could be defined as 'other securities equivalent to shares' under Art. 4(1)(18)(a) of the MiFID Level 1 Directive and therefore be assessed against the Art. 38 criteria. Moreover, the respondent pointed out that the Prospectus Directive treats them as equivalent. Another respondent also thought that Spanish 'participaciones preferentes' should be assessed against the Art. 38 criteria for the same reason.

81. One respondent presented a considered case as to why Danish mortgage bonds should be treated as non-complex instruments under MiFID.

CESR's response

Regarding covered bonds and structured covered bonds, CESR accepts that on and off-balance sheet forms of these types of bonds can be seen to be different in legal form only. However, CESR's view remains that structured covered bonds should not be treated as automatically non-complex instruments for the purposes of the appropriateness requirements, bearing in mind that this is concerned with non-advised transactions for retail clients. While CESR can see the attraction in employing UCITS Art. 22(4) as a factor in distinguishing between different covered bond structures, such a cross-reference would, in CESR's view, require an amendment to MiFID. Therefore, considering the text of MiFID as it stands, CESR considers that – pending the future review of MiFID – structured covered bonds should not be treated as automatically non-complex. Those structured covered bonds that embed a derivative and those that incorporate structures which make it difficult for the investor to understand the risk attached to the product should be considered as complex products. Other structured covered bonds should be assessed against the Art. 38 criteria. The likely result of such an assessment is that almost all, if not all, such bonds will be considered complex, especially if the investor has no recourse to the financial institution that has issued or sponsored the instrument.

Considering comments received regarding Spanish *participaciones preferentes* their treatment has been assimilated to preference shares for the purposes of the appropriateness requirements. Therefore, as stated in response to Question 3, when they embed a derivative they should be considered as complex products. These instruments will therefore not be addressed in a separate section in the Q&As.

CESR's understanding is that Danish mortgage bonds are wholly excluded from the scope of Art. 19 of MiFID, under Art. 19(9) of the Level 1 Directive. Therefore, the MiFID appropriateness requirements do not apply to these instruments.

82. In Section 2, CESR also discussed the categorisation of subordinated bonds, depositary receipts in respect of bonds or other forms of securitised debt.

83. CESR asked the following questions:

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?

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

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

84. Regarding question 18, while a number of respondents considered that there may be a case to review MiFID's treatment of debt instruments, others did not.

85. The respondents that did not agree with CESR thought that debt instruments are addressed sufficiently clearly in MiFID with regard to the appropriateness test and therefore did not see any need for a review. Another respondent thought that the Art. 38 criteria should be able to accommodate such changes as those mentioned in the CP. This respondent also suggested that some of the products in question have not generally been considered as retail products and are usually accessed through an intermediary. The respondent also argued that obstacles should not be put in the way of willing market participants who have expertise in the markets in the relevant instruments, and are prevented from being classified as professional clients only by virtue of the size tests. The respondent believes it should continue to be possible for investment firms to make judgements of appropriateness by virtue of the clients' long-standing participation in particular markets.

86. One respondent who did agree with CESR thought 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.

87. Most respondents to question 19 did not have any further comments on CESR's consideration of the position of bonds and other forms of securitised debt. One respondent, however, argued that the MiFID appropriateness test is not adequate protection and that retail investors need to be much more thoroughly informed and advised about the risks they face in the fixed income markets. Several other respondents argued that the risks associated with subordinated bonds (or 'junior bonds') suggested that these instruments should not be treated as non-complex instruments. It was suggested that subordination should be included by MiFID among the factors for assessing whether an instrument is complex or non-complex.

88. On question 20, most respondents did not think there were any other specific types of such instruments that should be explicitly mentioned for the purposes of CESR's exercise. One respondent was again of the view that there should be no common list. Another respondent thought that 'step up notes' and 'floating rate notes' could be mentioned as non-complex. A further respondent questioned the lack of any specific reference to bonds involving interest rate derivatives in the list of complex instruments.

CESR's response

Although respondents' views varied on the question of whether MiFID's approach to debt instruments needs to be reviewed, there do seem to be some questions that should be considered further. One of these is the point about the possible case for greater differentiation between types of debt instrument. This is a point that CESR specifically raised in the CP.[4] Such further consideration might consider the need for further differentiation between types of bond covered by MiFID – including the treatment of subordinated bonds (whose risks CESR noted in its CP).

CESR notes the concern of the respondent to question 19 that more information should be disclosed to clients about the risks involved in the fixed income markets. As it has stressed in the CP and in this Feedback Statement, however, CESR believes that there are requirements both in MiFID and elsewhere that should require adequate information to be disclosed to clients if they are properly followed.

Regarding question 20, CESR reiterates that it is not its intention to provide an exhaustive list of instruments. On the question of 'step-up notes' and floating rate notes, CESR has the following comments.

CESR understands step-up notes to be debt securities, usually callable, with interest rates that increase over time. If the notes are not called by the issuer, their coupons increase according to a predefined schedule. For the purposes of the appropriateness requirements, callable step-up notes will not be non-complex as they embed a call option. Non-callable step-up notes that simply move to a higher interest rate after a pre-defined time period may be treated as non-complex debt securities because they do not embed an option.

Floating-rate notes are notes with a variable interest rate. Given the different variations and structures of floating rate notes, CESR again would not consider such instruments as automatically non-complex. These notes should therefore be assessed against the Art. 38 criteria – including the first criterion covering derivatives and similar instruments. CESR has included these two types of instruments in its final Q&A.

CESR did not mention instruments involving interest rate derivatives more widely because it does not regard these as instruments likely to be traded in any volume by retail investors on a non-advised basis. However, the respondent that raised this point had a real example of such a situation. CESR can confirm that interest rate derivatives, and products embedding them, will be complex instruments under the appropriateness requirements, requiring the appropriateness test to be satisfied.

V Section 3 – UCITS and other collective investment undertakings

89. In the CP, CESR noted that under Art. 19(6) of the MiFID Level 1 Directive, UCITS are automatically non-complex for the purposes of the appropriateness requirements. CESR also explained its view that units in other types of collective investment undertakings within the scope of Annex I to the MiFID Level 1 Directive will need to be assessed against the Art. 38 criteria.

90. CESR asked the following question:

[4] In paragraph 65, CESR stated that development of fixed income markets in the last decade on both volumes and complexity has been very significant, and it is doubtful that Art 19(6) as it currently stands is a helpful starting point to achieve an appropriate degree of investor protection. Particularly given recent developments in the financial markets, CESR believes 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 than Art. 19(6)'s listing of money market instruments, bonds and other forms of securitised debt.

Question 21: Do you agree with CESR's view that non-UCITS undertakings should not automatically be categorised as complex instruments simply due to the fact that they invest in complex instruments?

91. Most respondents to this question agreed with CESR's view. Some respondents emphasised CESR's point that such undertakings should only be categorised as complex if they fail to satisfy all the criteria in Art. 38. Another respondent suggested that the right approach would be to align the treatment of collective investment undertakings under EU law.

92. However, a few respondents questioned CESR's view that UCITS themselves should be treated as non-complex products regardless of the underlying instruments in which the UCITS invests. One respondent was concerned that a retail client may invest in a UCITS perceiving it to be non-complex despite the fact that the underlying instruments may be complex. The respondent's view is that the UCITS category should reflect the nature of the investments contained within it, particularly since the nature of the UCITS 'brand' had expanded over time. For instance, a UCITS containing predominately structured products should be considered to be complex.

CESR's response

CESR has considered the responses to this question and retains the position it set out in the CP that non-UCITS undertakings should not automatically be categorised as complex instruments simply due to the fact that they invest in complex instruments. A unit or share in a non-UCITS collective investment undertaking can be categorised as a non-complex instrument if it fulfils all the Art. 38 criteria. However, CESR notes the Commission's proposal for a Directive on Alternative Investment Fund Managers (AIFMD), which will have a bearing on non-UCITS funds, and their final treatment for the purposes of the appropriateness requirements may be prescribed by the AIFMD. (Please also see the following paragraphs where these issues are discussed further.)

Regarding the treatment of UCITS, CESR notes the respondents' concerns but would reiterate the point that nothing in Art. 19(6) of MiFID Level 1 requires a person to look through to the underlying investments of the UCITS for the purposes of the appropriateness requirements. As drafted, Art. 19(6) treats all UCITS as automatically non-complex.

Any review of the treatment of UCITS, as well as the question of greater alignment in the treatment of UCITS and non-UCITS collective investment undertakings, is an issue for the European Institutions to consider (including through the AIFMD).

How should undertakings such as Exchange Traded Funds (ETFs), capital protected funds or hedge funds be categorised?

93. Regarding ETFs, CESR stated in the CP that ETFs which are structured as UCITS will be automatically non-complex. ETFs which are non-UCITS will need to be assessed against the Art. 38 criteria. CESR proposed the same distinction for capital protected funds, according to whether they are UCITS or not.

94. CESR also considered that hedge funds are currently in the same position, although a hedge fund is traditionally less likely to be authorised under the UCITS Directive. Non-UCITS hedge funds would need to be assessed against the Art. 38 criteria.

Can different treatments of units in collective investment undertakings be justified on policy grounds?

95. CESR suggested in the CP that it believed that not all UCITS should necessarily be regarded as automatically non-complex investments for the purposes of the appropriateness requirements, notwithstanding the current drafting of the Directive. It considered a range of

possible consequences of the treatment of UCITS and non-UCITS investments under Art. 19(6), and noted the Commission's expected proposals on alternative investment funds (subsequently published). CESR suggested that negotiations would provide an opportunity for some of these issues to be considered further by stakeholders.

96. CESR asked the following questions:

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

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

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?

97. Regarding question 22, most respondents agreed with CESR's interpretation of the treatment of units in collective investment undertakings under Art. 19(6). However, some respondents qualified their agreement and were less happy with the questions CESR raised about whether the MiFID treatment remained correct.

98. One respondent agreed with CESR's analysis except in the case of ETFs. In this respondent's opinion, where ETFs are listed and traded on a stock exchange, they should be treated in the same way as shares for the purposes of the appropriateness requirements. On the other hand, another respondent disagreed that ETFs authorised as UCITS should automatically be deemed non-complex for appropriateness. This respondent thought a distinction should be made between ETFs that fully replicated an index (or by sampling) and 'synthetic' index replicating ETFs which can pose other (less clear) risks for the retail investor. The respondent elaborated that synthetic ETFs do not actually hold the relevant index's components in their portfolio but mostly fixed income securities and derivatives.

99. One respondent thought that further guidance should be provided with respect to non-UCITS to ensure greater convergence in treatment for the purposes of the appropriateness requirements. Another respondent observed that conceptually, the categorisation of instruments for investor protection purposes should be related to the risks of instruments rather than their complexity. However, this respondent commented that, since practical solutions have been established, this consideration would not justify a review of MiFID in this respect, at this time.

100. Most of the respondents to question 23 disagreed with CESR's view that, if the appropriateness requirements were reviewed, then there might be a case for not treating all UCITS automatically as non-complex for the purposes of these requirements. Respondents gave a variety of reasons why they disagreed. Some simply stated that this interpretation is contrary to MiFID as agreed. Others stated that UCITS clearly meet the four criteria set out in Art. 38 of the MiFID Level 2 Directive. One respondent argued that UCITS are very liquid, do not involve any liability exceeding the acquisition cost, provide a very high level of disclosure to retail investors, are subject to stringent risk management rules and are well diversified. Respondents also argued that UCITS are conceived as retail products, are very strictly regulated, and provide a high degree of investor protection. One respondent suggested that reviewing MiFID in this area would create legal uncertainty which would not deliver additional effective protection to investors.

101. In respect of question 23, some respondents pointed out that CESR's proposal that non-UCITS undertakings should not automatically be categorised as complex instruments now appears inconsistent with the Commission's proposed Directive on Alternative Investment

Fund Managers (which proposes to amend MiFID so that all Alternative Investment Funds are treated as complex for the purposes of the appropriateness requirements).

102. One respondent suggested that, particularly as far as marketing is concerned, further clarification was desirable about the interaction between the MiFID and UCITS frameworks in order to achieve a more coherent approach.

103. Regarding question 24, one respondent thought that putting hedge funds and funds of hedge funds in the same basket could lead to inappropriate conclusions. This respondent suggested that hedge funds have become increasingly accessible to mass affluent and retail investors through funds of hedge funds. Depending on jurisdiction, these funds of hedge funds may be subject to stringent requirements that allow them to satisfy the Art. 38 criteria and therefore qualify as non-complex products.

104. Some respondents thought that non-UCITS undertakings that qualify as suitable investments for UCITS undertakings under Art. 19(1)(e) of the UCITS Directive should qualify as non-complex instruments.

105. Some respondents particularly mentioned the position of investment companies, which they felt should be treated in the same way as UCITS, given the requirements governing them.

CESR's response

Regarding question 22, there were two main issues raised: the treatment of ETFs and of non-UCITS.

Concerning ETFs, CESR can see the arguments for distinguishing between types of ETF such as 'physical or 'full replication' ETFs and other ETF structures such as swap based ETFs or synthetic index replicating ones which could generate additional risks for retail investors. However, CESR feels that these distinctions will be accommodated under its original proposal that ETFs which are structured as UCITS will be automatically non-complex (because MiFID treats all UCITS as non-complex), and ETFs which are non-UCITS will need to be assessed against the Art. 38 criteria. Non-UCITS ETFs with more complex strategies are less likely to satisfy all the Art. 38 criteria.

CESR agrees that further guidance might usefully be provided to clarify the interaction of the MiFID and UCITS regimes and their treatment of UCITS and non-UCITS. CESR also recognises the need to consider the outcome of negotiations on the Alternative Investment Fund Managers Directive (AIFMD) in the treatment of non-UCITS funds. The Commission's proposal for the Directive had not been published when CESR's CP was issued.

Regarding question 23, the most significant comments related to the issue of whether all UCITS should be regarded as automatically non-complex. CESR recognises that, as the rules stand, all UCITS are automatically non-complex, but was raising the question of whether this remains a correct approach. CESR notes the comments of some respondents that the UCITS category should reflect the nature of the investments and that a renewed policy debate should be initiated.

On the suggestion that non-UCITS qualifying as suitable investments for UCITS undertakings under Art. 19(1)(e) of the UCITS Directive should qualify as non-complex instruments under MiFID, CESR can see the argument, but would expect the outcome of applying the Art. 38 criteria to be generally consistent with this. Sensible outcomes should also result from applying the Art. 38 criteria to investment companies.

Funds of hedge funds that are not UCITS should be assessed against the Art. 38 criteria, pending the outcome of negotiations on the AIFMD.

VI Section 4 – 'Other non-complex financial instruments' under Art. 38 of the Level 2 Directive: Issues of general interpretation

106. In this section, CESR noted the rationale for the criteria in Art. 38 of the Level 2 Directive (i.e. that it is not practical for the MiFID Level 1 Directive to attempt to list all types of financial instruments that may, then or in the future, be treated as 'non-complex' for the purposes of the appropriateness requirements). Although there is scope for interpretation in applying some of the criteria, the high-level aim of Art. 38 is to confine the scope of 'other' non-complex instruments to those products that are adequately transparent, liquid, and capable of being readily understood by retail clients. MiFID derivatives and certain similar instruments cannot qualify as 'non-complex' under the criteria.

107. CESR asked the following question:

Question 25: Do you agree with CESR's view on the purpose of the Art. 38?

108. Most respondents to this question agreed with CESR's views. However, one respondent questioned whether, under MiFID, any instruments were automatically not non-complex and suggested that an assessment is always needed under Art. 38.

CESR's response

MiFID clearly provides in Art. 19(6) of the MiFID Level 1 Directive that specific types of instruments/products can always be treated as non-complex and then provides in Art. 38 of the Level 2 Directive a set of criteria for 'other non-complex' products not specifically listed. These provisions, taken together, indicate some specific types of MiFID products that should always be treated as 'complex' for the purposes of the appropriateness requirements. As noted earlier, for example, instruments within the scope of the first of the Art. 38 criteria will always be complex instruments.

Consideration of each criterion

109. The CP considered each criterion in Art. 38 and their practical implications.

110. CESR asked the following question:

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

111. While most respondents broadly agreed with CESR's interpretation, some had reservations or additional suggestions. One respondent believed that CESR's interpretation was too vague, particularly, they argued, when for some securities automatically considered as non-complex, there may be few opportunities for retail investors to dispose of them in a non-penalising way (e.g. corporate bonds).

112. Two respondents suggested that CESR might consider a maximum frequency of 30 days as to what constitutes frequent opportunities to trade. One respondent stated that in its view, any period of time in excess of one month should be considered infrequent. One cited a former rule in a national Deposit Guarantee Scheme that stated that a deposit is liquid if you can withdraw it with 30 days notice. Another respondent suggested that guidance as to what is meant by 'frequent opportunities' could consider the UCITS regime, with any fund dealing less frequently than this likely to be regarded as 'complex'. (The respondent pointed out that UCITS are generally dealt daily and cannot have dealing periods more infrequent than twice a month.)

113. Some respondents pointed out that the frequency of redemption alone does not seem sufficient to assess the complexity of a financial instrument. Secondary markets, market

practice and general market conditions have to be taken into account. In addition, one respondent stated that rather than cite daily or weekly redemption, it would seem essential that the investor receives clear information on redemption dates before investing, and can therefore understand the redemption mechanisms of the financial instrument in question.

CESR's response

CESR believes that any interpretation of 'frequent opportunities' must be able to accommodate a range of frequencies: daily, weekly and possibly longer regular frequencies. In developing the CP, CESR did consider whether to suggest the ordinary and extraordinary frequency of the UCITS regime as a benchmark. However, CESR concluded that in many cases 30 days would probably be too long in terms of market norms, and noting that where the normal market frequency is not obvious, firms should consider this criterion on a case-by-case basis.

CESR agrees that frequency of redemption alone is not sufficient to assess a financial instrument and that secondary markets practice and general market conditions have to be taken into account. CESR also agrees that clear information to investors on any specific redemption dates is important to assist their understanding of an instrument.

114. CESR stated in the CP that in general, it believes that prices are publicly available to market participants when they are easily accessible through channels that are easy to find for the relevant clients. For example, it may be considered that prices are publicly available when MiFID pre- and post-trade transparency requirements, or similar national requirements for financial instruments other than shares, apply.

115. CESR asked the following question:

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?

116. Most respondents who commented on this question agreed with CESR's view. One respondent who did not agree commented that even for some securities automatically deemed non-complex by MiFID (notably fixed income products), there are often no prices 'easily accessible through channels that are easy to find for the relevant clients'.

117. Some respondents suggested that CESR specify that net asset values published by investment funds in line with the relevant UCITS requirements are sufficient for the purposes of this criterion. Funds which calculate their redemption prices under supervision of or in cooperation with a depositary, custodian or independent party should therefore be deemed to meet this requirement.

118. Another respondent considered that the requirement for objective valuation might also be met when valuation is made by the issuer itself, in compliance with MiFID's conduct of business rules.

CESR's response

CESR has noted the point in regard to the fixed income market in paragraph 65 of the CP.

CESR accepts that where funds calculate their redemption prices under supervision of or in cooperation with a depositary, custodian or independent party, these should be deemed to meet this element of the criterion.

However, CESR does not consider that the non-market price requirement would be satisfied simply by an objective valuation made by the issuer itself in compliance with MiFID's conduct of business

rules. Such an evaluation would need to be verified independently of the issuer, for the reasons stated in the CP.

CESR agrees that the net asset values published by investment funds in line with the relevant UCITS requirements are sufficient for the purposes of the criterion.

119. CESR stated in the CP that the admission to trading of a product offers the potentiality of having frequent opportunities to dispose of, redeem, or otherwise realise that instrument but does not ensure that in practice a range of frequencies will exist. Similarly, the existence of prices publicly available (determined by the market or by valuations systems) does not automatically ensure that Art. 38(b) of the MiFID Level 2 Directive will be satisfied, if frequent opportunities to trade do not exist. Firms will need to be particularly diligent when considering securities on a market where liquidity is thin.

120. CESR asked the following question:

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

121. Most respondents broadly agreed with CESR's views, though a number had additional points to make.

122. In some respondents' view, liquidity should not be a decisive factor in relation to determining whether a financial instrument is complex. One respondent proposed that CESR should clarify that a lack of liquidity would have to be assessed first in view of the redemption dates and available market, and that secondly, a case-by-case analysis could be required of an investment firm becoming aware of changing market conditions which might affect liquidity.

123. Another respondent stated that to create an obligation for investment firms to – on a day to day basis – monitor the liquidity of a certain regulated market (to ensure that the Art. 38 criterion was satisfied) would be disproportionate. This respondent argued that the requirements in MiFID on transparency and efficiency should be sufficient for the purposes of the criterion.

124. Another respondent suggested that to ensure uniform interpretation of references to liquidity in EU regulations, Art. 2(1) of the UCITS Eligible Assets Directive should be recognised, as well as CESR's guidelines concerning eligible assets for investment in UCITS. This respondent suggested that the factors to be considered should be the volume and turnover in the financial instrument, evaluation of the opportunity to trade, and timeframe to trade. The respondent also proposed that the number of intermediaries and market makers dealing in the financial instrument admitted to trading on a regulated market should be taken into account in assessing the quality of secondary market activity in a financial instrument. Financial instruments admitted to trading on a regulated market should be accepted as meeting the liquidity requirement, along with financial instruments providing for at least half-yearly redemption opportunities.

CESR's response

CESR agrees that liquidity assessments will need to consider redemption dates and available secondary markets. A case-by-case analysis may be required if an investment firm becomes aware of changing market conditions which might affect liquidity. But CESR also agrees that an obligation for investment firms to monitor on a daily basis the efficiency of a regulated market would be disproportionate. CESR does not feel able to confirm that all products admitted to trading on a regulated market will automatically satisfy the criterion. There may be exceptions, and CESR particularly reiterates its position in the CP that firms will need to be particularly diligent when considering securities trading on a market where liquidity is thin.

CESR acknowledges the need to seek consistency across references to liquidity in other relevant Directives and will look to do this.

125. In the CP, CESR considered the circumstances where the client may have an actual or potential liability that exceeds the cost of acquiring the instrument. CESR stated that in regard to Art. 38(c) of the Level 2 Directive, the existence of an actual or potential liability can be understood as the possibility that, at any time, the investor runs the risk of being liable to make a payment above the initial outlay made in order to acquire the instrument (i.e. the cost of the instrument itself as well as the commissions and fees charged).

126. CESR asked the following question:

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

127. Most respondents agreed with CESR on both segments of this question.

128. One respondent proposed that CESR clarify that if the potential loss which the investor may incur with respect to holding of financial instrument is limited to the amount paid for its acquisition, those instruments should satisfy Art. 38(c). Another respondent also believed that further clarification is required. The respondent stated that 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, spread, etc.

CESR's response

CESR believes that the wording in Art. 38, taken together with the discussion in the CP, provides sufficient clarity, including on the two specific points above.

129. CESR also discussed in Section 4 its interpretation of what adequately comprehensive information means and when it can be considered to be publicly available in the context of Art. 38(d).

130. CESR asked the following question:

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

131. Most respondents generally agreed with CESR, though some thought that more clarity could be given around what constitutes publicly available information, or suggested amplifying some of CESR's points.

132. One respondent said that the key point is that information for investors on all financial instruments should be fair, clear and not misleading. Another commented that the answer to the question of when information can be said to be publicly available for retail investors, especially those who do not follow the markets, should be less prescriptive and accommodate flexibility.

133. Another respondent agreed with CESR, in principle, but thought that some improvements to current European standards might be necessary to meet CESR's stated standard. This respondent also commented that information on liquidity and counterparty risk is often undisclosed.

134. Some respondents argued that information comparable to a UCITS prospectus or a KID should be considered as comprehensive and publicly available information. Another argued

that product information in the client's language available and/or provided in a durable medium by an information agent in the investor's jurisdiction should be considered comprehensive and publicly available information. These respondents also sought clarification that the length of a prospectus has generally no impact on the assessment under Art. 38(d).

CESR's response

CESR acknowledges that the discussion in the CP as to what could be considered as comprehensible and publicly available information cannot be considered exhaustive or complete.

CESR believes that this issue is not overly complicated, and that the CP sets out reasonable guidelines as to when it can be considered that information is adequately comprehensive or publicly available. However, this may be an area that needs to be revisited in the future in the light of standards and practices in the market, should standards appear inadequate.

CESR agrees that information comparable to a UCITS prospectus or other form of documentation recognised by EU law and produced to that standard should usually be considered as comprehensive information.

CESR also agrees that product information in the client's language provided in a durable medium by an information agent in the investor's jurisdiction could be considered publicly available information. However, CESR reiterates its point in the CP that the information should be readily understandable so as to enable the average retail client to make an informed judgement as to whether to enter into a transaction in that instrument.

CESR agrees that the simple volume of information (e.g. length of a prospectus) need not be a determining factor under Art. 38(d), where a shorter document is adequately comprehensive.

Information can be considered publicly available if it is produced in compliance with the Prospectus Directive.

CESR would expect liquidity and counterparty risks to be disclosed to potential investors as relevant and appropriate, in accordance with MiFID's general obligations on risk disclosure.

VII Section 5 – Other products

135. In this section, CESR briefly considered certain other instruments or products that had not been explicitly covered in previous sections of the CP. CESR confirmed that (as MiFID stands) the appropriateness requirements do not apply to deposits, loans, mortgages or life insurance products as they are not MiFID financial instruments. The exception to this is that the Commission regards a deposit with an embedded derivative that has the potential to reduce the initial capital invested as a financial instrument under MiFID.

136. CESR also considered Exchange Traded Commodities (ETCs) in this section. CESR concluded that some ETCs will need to be treated as complex for the purposes of the appropriateness test (notably where they are structured as contracts for differences). For others, firms will need to consider the regulatory classification in each case for the purposes of the appropriateness test.

137. CESR asked the following questions:

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

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 comprehensible information about the type of instruments(s).

138. Regarding question 31, while some respondents agreed that a deposit with an embedded derivative, which has the potential of reducing the initial capital invested, should be classed as a financial instrument under MiFID, some questioned this inclusion. Some questioned whether such deposits would typically satisfy the criterion of transferability.

139. One respondent commented that the fact that deposits, loans, mortgages and life insurance were not covered by MiFID was a weakness.

140. Regarding ETCs, some respondents questioned CESR's view that some ETCs are (in part) contracts for differences. These respondents thought that ETCs should be treated as non-complex instruments for the purposes of appropriateness. Another respondent proposed that the issuer should assess the product under Art. 38 and that the national supervisor can express an opinion in this respect during the prospectus vetting phase.

141. Most respondents to question 32 did not identify any other specific instruments that should be explicitly mentioned in a list for the purposes of CESR's exercise. One respondent however stated that the list should mention 'all substantive products'.

CESR's response

Regarding a deposit embedding a derivative, the Commission regards this instrument as a financial instrument under MiFID because the deposit has the potential to reduce the initial capital invested. A normal bank deposit would not have this inherent risk.

Regarding ETCs, CESR reiterates its views that a range of different ETC structures exist. For example, some are debt securities; some involve the features of a CFD. The treatment of such instruments for the purposes of appropriateness may vary accordingly, though it is likely that most ETCs will not be capable of being treated as non-complex instruments for the purposes of the appropriateness requirements. Those that are CFDs, or other securities giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures, will be complex instruments because they will not meet all the Art. 38 criteria. Any that are structured as debt securities that embed a derivative would also not be non-complex.

CESR would also clarify that ETCs and ETFs (Exchange Traded Funds) are different types of instrument.

Annex 1: List of Responses

Activity	Name
Banking	Association of Danish Mortgage Banks
Banking	Association Francaise des Tresoriers d'Entreprise (AFTE)
Banking	WKO
Banking	European Savings Bank Group (ESBG)
Banking	European Association of Co-operative Banks (EACB)
Banking	European Banking Federation
Individuals	Bocconi University, Milan
Individuals	Prof. Riccardo Cesari, Università di Bologna
Individuals	Prof. Rita D'Ecclesia, Università di Roma
Individuals	Prof. Umberto Cherubini, University of Bologna
Insurance, pension & asset management	Assogestioni
Insurance, pension & asset management	EFAMA
Insurance, pension & asset management	Investment Management Association (IMA)
Insurance, pension & asset management	INVERCO
Investment services	ALFI
Investment services	Association Francaise des Marches Financiers (AMAFI)
Investment services	Association Française de la Gestion Financière (AFG)
Investment services	AssoFinance
Investment services	Brewin Dolphin Limited
Investment services	BVI Bundesverband Investment und Asset Management e.V.
Investment services	CNMV Advisory Committee
Investment services	Joint response from Danish Securities Dealers Association and Danish Bankers Association
Investment services	European Covered Bond Council
Investment services	Federation of Finnish Financial Services
Investment services	Joint response from APCIMS, LIBA and BBA
Investment services	Nordic Securities Association
Investment services	Swedish Securities Dealers Association
Issuers	The Quoted Companies Alliance
Others	CGIL - Italian trade union
Others	Danish Shareholders Association
Others	FIN-USE
Others	Financial Services Consumer Panel
Regulated markets, exchanges & trading systems	Irish Stock Exchange
Regulated markets, exchanges & trading systems	London Stock Exchange Group