

## CySEC Circular on ESMA Guidelines for complex debt instruments and structured deposits

CySEC has recently issued a Circular drawing the attention of Investment Firms to the Guidelines for complex instruments and structured deposits issued by ESMA in February 2016. The purpose of these guidelines is to clarify the concept of “**embedded derivatives**” and specify the criteria for the assessment of:

- a. Debt instruments incorporating a structure which makes it difficult for the client to understand the risks involved;
- b. Structured deposits incorporating a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term.

According to Article 25(4)(a) of MIFID II, EU member states shall allow investment firms when providing investment services that only consist of execution or reception and transmission of client orders with or without ancillary services, to provide those services without the need to obtain information about the experience and knowledge of the clients if the services relate to any of the following instruments:

- i. shares admitted to trading on a regulated market or on an equivalent third-country market or on a MTF, where those are shares in companies, and excluding shares in non-UCITS collective investment undertakings and shares that embed a derivative;
- ii. bonds or other forms of securitised debt admitted to trading on a regulated market or on an equivalent third country market or on a MTF, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;
- iii. money-market instruments, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;
- iv. shares or units in UCITS, excluding structured UCITS as referred to in the second subparagraph of Article 36(1) of Regulation (EU) No 583/2010;
- v. structured deposits, excluding those that incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term;
- vi. other non-complex financial instruments.

### Debt instruments embedding a derivative

For the purpose of instruments listed in (ii) & (iii) above, an **embedded derivative** is a component of a debt instrument that causes some or all of the cash flows that otherwise would result from the instrument, to be modified according to one or more defined variables.

### Debt instruments incorporating a structure making it difficult for the client to understand the risk

For the purpose of instruments listed in (ii) & (iii) above, debt instruments incorporating a structure making it difficult to understand the risk should include inter alia any of the following:

- a. Debt instruments, the return of which is dependent on the performance of a defined asset pool;
- b. Debt instruments, the return of which is subordinated to the reimbursement of debt held by others;
- c. Debt instruments where the issuer enjoys discretion to modify the cash flows of the instrument;
- d. Debt instruments lacking a specified redemption or maturity date;
- e. Debt instruments having an unusual or unfamiliar underlying;
- f. Debt instruments with complex mechanisms to determine or calculate the return;
- g. Debt instruments structured in a way that may not provide for a full repayment of the principal amount;
- h. Debt instruments issued by a special purpose vehicle;
- i. Debt instruments with complex guarantee mechanisms;
- j. Debt instruments with leverage features.

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

For the purpose of instruments listed in (v) above, a structure making it difficult for the client to understand the risk of return exists where:

- a. more than one variable affects the return received; or
- b. the relationship between the return and relevant variable or the mechanism to determine or calculate the return is complex; or
- c. the variable involved in the calculation of the return is unusual or unfamiliar to the average retail investor; or
- d. the contract gives the credit institution or the investment firm the unilateral right to terminate the agreement before maturity.

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

For the purpose of instruments listed in (v) above, a structure making it difficult for the client to understand the cost of exiting the product before term exists where the exit cost is:

- a. neither a fixed sum;
- b. nor a fixed sum for each month (or part thereof) remaining until the end of the agreed term;
- c. nor a fixed percentage of the amount deposited.

Should you wish to obtain more information or seek advice on the application of these Guidelines you can contact us at [info@mnkriskconsulting.com](mailto:info@mnkriskconsulting.com).