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15 June 2015

Guidelines on complex debt instruments and structured deposits

This is the response of the UK's Financial Services Consumer Panel on the ESMA draft guidelines on complex debt instruments and structured deposits under MiFID II. The Consumer Panel provides advice and challenge to the UK's Financial Conduct Authority (FCA) on the extent to which the FCA's general policies and practices are consistent with its general duties. The Panel represents the interests of all groups of financial services consumers and operates independently of the FCA.

The Panel takes a keen interest in the protection of retail investors, and has followed the negotiations surrounding MiFID II closely. While the Panel does not have the technical expertise to provide detailed comment on the proposed guidelines, it has repeatedly underlined the need for better protection for retail investors when making a non-advised purchase of complex investment products.

The Panel outlined many of the problems faced by retail investors when conducting a non-advised sale in its 2013 research on the UK annuities market.¹

Sales conducted without the provision of investment advice often have opaque potential risk and returns and offer greatly reduced consumer protection if things go wrong. Moreover, intermediaries can also be subject to inappropriate incentives that lead to commission bias, which see products and services recommended to investors in spite of the fact that they are not appropriate for the customer's circumstances.

The Panel has therefore welcomed the extension of MiFID's provisions to ensure that a larger range of complex investment products can only be sold on a non-advised basis following an 'appropriateness' test.²

It strongly supports the contents of the draft guidelines, which capture the types of products currently available that should be considered complex, in particular those with structures that are unlikely to be understood by average investors. It is important that the guidelines offer regulators sufficiently flexibility to capture new or re-designed products within the definition of 'complex', so that these do not escape the requirement to be subject to an appropriateness test where sold on an execution-only basis.

The Panel would welcome clarification on whether counter-party risk for structured products would also be taken as a feature that makes a product complex. Many retail investors are unlikely to appreciate the risk of losing money not because of the performance of the product, but because of the failure of the counter-party that backs the product and which may not be covered by a Member State compensation scheme.

However, the Panel also holds the view that in the longer term there is a real need for a fundamental review of the basis on which the classification of a product as 'complex' is made. Rather than using a set of pre-defined product features, the starting point for determining whether

¹ https://fs-cp.org.uk/sites/default/files/annuities_position_paper_20131203.pdf

² https://fs-cp.org.uk/sites/default/files/cp_letter_to_european_commission_on_mifid_2_level_2_measures_20150327.pdf

a product is to be considered complex should be dependent on the financial capability of the average retail investor.

The determination should therefore be made on a case-by-case basis, and be based primarily on the knowledge and background of each specific customer. This requires a principles-based approach that can be deployed flexibly and fairly, instead of an approach that relies on a list of concrete characteristics of a product, as these may become outdated or offer 'safe harbour' opportunities for firms.

In this respect, it may be helpful for ESMA to take into account the definition proposed by IOSCO, which defined a "complex financial product" as a "financial product whose terms are not likely to be understood by an average retail investor, where the product has a complex structure, is difficult to value without specific skills/systems and/or has a very limited or no secondary market and is therefore potentially illiquid".³

Yours sincerely,



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Financial Services Consumer Panel

³ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf>