AMF Position 2010-05
Marketing of complex financial instruments

References: Articles L. 533-11 up to L. 533-13 and article L. 541-8-1 of the Monetary and Financial Code; articles 314-10, 314-18, 314-33 up to 314-36 and article 325-5 of the AMF General Regulation

Background

The AMF is tasked with protecting retail investments in financial instruments offered to the public or admitted to trading on a regulated market and in all other investments offered to the public[1]. Faced with the asymmetry of information that exists between retail clients and producers and distributors of structured UCITS or AIF and complex debt securities (including in particular complex EMTNs), the difficulties experienced by retail clients in understanding such products, and the risk that entities who market them may fail to comply with requirements, the Authority has decided to publish a Position on the direct marketing of such products.

The ACPR[2], which is charged with protecting clients of insurance entities, scrutinises such financial instruments when used as investment vehicles for life insurance policies. Consequently, the ACPR decided to adopt a recommendation on the use of structured financial instruments that carry a mis-selling risk as underlyings for unit-linked policies. The recommendation explains how insurance entities and intermediaries can comply with their statutory and regulatory obligations with regard to disclosure and advice.

The AMF position:

- reiterates the responsibility placed upon investment services providers (including when they act through a tied agent), financial investment advisers and direct marketers of banking and financial services to properly inform retail clients about structured UCITS and AIF and complex debt securities (including in particular complex EMTNs);
- reminds investment service providers (even when acting through a tied agent), financial investment advisers and direct marketers of banking and financial services of the objective criteria for mis-selling risk with regard to complex financial instruments.

[1] Article L. 621-1 of the Monetary and Financial Code.
[2] Autorité de contrôle prudentiel et de résolution recommendation on the marketing of unit-linked life insurance products made up of complex financial instruments, issued in accordance with 3° of II of Article L. 612-1 of the Monetary and Financial Code.

CONTENTS

1. Scope of the AMF Position

1.1 Financial instruments concerned

The AMF position applies to the following financial instruments:

- French structured funds referred to in Article R. 214-27 of the Monetary and Financial Code;
- French structured AIF referred to in Article R. 214-32-39° of the Monetary and Financial Code
- equivalent foreign structured UCITS[3] and AIF;
- complex debt securities and equivalent foreign securities, except for ordinary warrants, i.e. products that are structured as warrants quoted continuously on a regulated market or a multilateral trading facility and giving the right (but not the obligation) to buy or sell a given asset for a set period at a price determined at issue.

This position does not apply to other financial instruments.

1.2 Situations concerned

The AMF position concerns marketing, defined as the presentation of a financial instrument through different means (advertising, direct marketing, , advice, etc.) by an investment services provider[4], a financial investment adviser, or a direct marketer of banking or financial services[5] with a view to encouraging a client to buy that instrument.

This position does not concern the sale of financial instruments:

- in response to a client's unsolicited request to purchase a specifically designated financial instrument, where allowed by the laws and regulations in force;
- under the terms of a portfolio management agreement, where the service is provided to the investment services provider, as long as the financial instruments in question are admissible for a retail client's portfolio.

[3] Structured UCITS are covered by Article 36 of Commission Regulation (EU) 583/2010 of 1 July 2010 implementing Directive 2009/65/EC.
[4] Or through a tied agent, as the case may be. The tied agent must comply with the laws and regulations applying to the investment services provider (Article L. 545-4 of the Monetary and Financial Code).
[5] For products subject to direct marketing.

1.3 Persons / entities concerned

The AMF position applies to the marketing of the aforementioned financial instruments in France. Accordingly, it applies to direct marketers of banking and financial services (as long as the financial instruments in question may be sold through direct marketing), to financial investment advisers and to all investment services providers[6] marketing the financial instruments in question in France, including those doing business under the freedom to provide services or the freedom of establishment.

The AMF position does not apply to the marketing of the financial instruments in question in other countries, even when French investment services providers are doing business under the freedom to provide services.

In the specific case of direct marketers of banking and financial services, these entities are required to comply with the conduct of business rules on disclosure, and their principals (mentioned in Article L. 341-3 of the Monetary and Financial Code) are "legally liable for the actions of direct marketers acting in that capacity"[7]. These entities could also be liable to sanctions imposed by the AMF Enforcement Committee for non-compliance[8].

The position concerns retail clients[9]. It does not apply to marketing to professional investors and/or eligible counterparties.

2. Producer's and distributor's obligations in the marketing of the financial instruments in question

2.1 Laws and regulations

Regulations cover four points: the primacy of clients' interests, client information, assessment of the suitability and appropriateness of the investment services to be provided and submission of marketing materials to the AMF.

Primacy of clients' interests

Investment services providers[10] are required to "act honestly, fairly and professionally in accordance with the best interests of its clients" and financial investment advisers[11] are required "to act honestly and fairly in the best interests of their clients".

Client information

Investment services providers are required to provide information that can be understood "by an average investor in the category at which it is addressed or by which it is likely to be received. It shall not disguise, diminish or obscure important items, statements or warnings."[12]

"Appropriate guidelines and warnings about the inherent risks of investing in such instruments or of certain investment strategies" must also be presented in understandable form[13].

[6] Or their tied agent(s).
[7] Article L. 341-4-III of the Monetary and Financial Code.
[8] Article L. 621-15, II of the Monetary and Financial Code.
[9] Article L. 533-16 of the Monetary and Financial Code.
[10] Articles L. 533-1, L. 533-11 of the Monetary and Financial Code and Article 314-3 of the AMF General Regulation. See Article 19, 1 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004.
[11] Article L.541-4 of the Monetary and Financial Code.
[12] Article 314-11 of the AMF General Regulation. See Article 27 of Directive 2006/73/EC of the Commission of 10 August 2006.
[13] Article 314-18 of the AMF General Regulation. See Article 19, 3 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004.

"Where the risks associated with a financial instrument composed of two or more different financial instruments or services are likely to be greater than the risks associated with any of the components, the investment services provider shall provide an adequate description of the components of that instrument and the way in which their interaction increases the risks."[14]

Assessment of the suitability and appropriateness of the investment service

Investment services providers must also do the following for their retail clients[15]:

- conduct a test of the appropriateness of the investment service or financial instrument offered or requested with regard to order reception and transmission services or execution-only services. This entails asking clients for information about their investment knowledge and experience;

- conduct a test of the suitability of the investment offered with regard to financial investment advice services. This entails asking clients for information about their investment knowledge and experience, as well as information about their financial situation and investment objectives.

The same applies to financial investment advisers who, when providing financial investment advice, are required to ask their clients or potential clients about their investment knowledge and experience, as well as their financial situation and investment objectives, in order to recommend transactions, instruments and services that are suited to their circumstances[16].

Submission of marketing materials to the AMF

All advertisements and marketing materials relating to a public offering or admission to trading on a regulated market shall be submitted to the AMF before being disseminated[17], even if the prospectus has already been passported[18].The same applies to marketing materials pertaining to harmonised French and European structured UCITS/AIF[19].

2.2 Position

The above provisions have the following consequences:

Distributors, whether investment services providers or financial investment advisers, that market the financial instruments concerned shall:

- establish a system to ensure that anyone marketing the product under their authority or on their behalf has a thorough understanding of the product and the information needed to provide suitable advice and appropriate service to clients;

- take into consideration in their assessment the profit margins of the various participants, especially when, in the structuring process, no competition has been organised between counterparties for the purposes of the best execution rules;

[14] Article 314-36 of the AMF General Regulation. See Article 31 of Directive 2006/73/EC of the Commission of 10 August 2006.
[15] Article L. 533-13 of the Monetary and Financial Code and Articles 314-43 and the following articles of the AMF General Regulation. See Article 19, 4 and 5 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004.
[16] Articles L. 541-4 and L. 541-8-1 of the Monetary and Financial Code.
[17] Article 212-28 of the AMF General Regulation.
[18] The prospectus approved by the home country authority is valid for a public offering or admission to trading on a regulated market, as long as the competent authority in each host Member State receives the relevant notification (Article 17 of Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading).
[19] AMF Instructions 2011-19 and 2011-20.

- consider the legal framework used to structure the product and, more specifically, any investor protection rules, other than the disclosure rules, (presence of a depositary, risk diversification rules, counterparty risk, etc.) when analysing the characteristics of the product;

- decide on the target clients for the product in light of an analysis of its advantages and disadvantages;

- make especially sure that the product's sole purpose is not to enable the indirect marketing of an underlying product that may not be sold directly to retail clients.

Furthermore, communications and materials pertaining to the financial instruments concerned and relating to a public offering or admission to trading on a regulated market, including where the prospectus has already been passported, as well as marketing materials pertaining to harmonised French and foreign structured UCITS/AIF, must comply with the instructions given in Annex 1, as applicable.

3. Determining objective criteria for assessing mis-selling risk

The AMF, in keeping with the ACPR recommendation on marketing unit-linked life insurance policies made up of complex financial instruments, has set four criteria for assessing whether retail clients are likely to understand the risks incurred with the financial instruments concerned and understand these instruments.

The criteria consider two types of risks:
a. the risk that clients will not understand the risks incurred;
b. the risk that clients will not understand the product being offered.

3.1 The risk that clients will not understand the risks incurred

This risk usually stems from:
- poor written and oral presentation of the product's risks and/or payoff profile (CRITERION 1);
- the retail client's lack of familiarity with the underlying assets (CRITERION 2);
- a payoff profile that relies on simultaneous occurrence of several conditions across different asset classes (CRITERION 3).

<u>Criterion 1: Poor presentation of the risks and payoff profile of the product</u>

The risk of poor presentation is potentially very high for the financial instruments concerned, where performance is sensitive to extreme scenarios (sudden market declines, changes in the economic environment, etc.), even if their probability of occurrence is very low[20]. This is particularly the case when such instruments are presented as combining performance with capital protection at maturity. The chances of making gains are presented as virtually assured and the scenarios outlined in the marketing materials are sometimes based solely on the most favourable assumptions.

A retail client is likely to misunderstand the risk because of the presentation of a financial instrument the performance of which is sensitive to extreme adverse scenarios.

[20] This type of product may be exempted from the "enhanced vigilance" approach if presented appropriately (see position below).

Example 1

A financial instrument that has a payoff profile described as "fixed return of 10% regardless of the level of the index, provided it is higher than its starting level, and capital loss equivalent to the decline in the index if the index falls by more than 40%" and that is poorly explained.

Criterion 2: retail clients' lack of familiarity with the financial instrument because of the underlying assets used.

Some financial instruments use underlying assets that are difficult for retail clients to understand and that cannot be observed individually on the market, such as the volatility of an asset or the correlation between several assets. The products in question composed of such underlying assets may be misunderstood by retail clients, who are also unable to monitor assets that are not readily available to the public.

Example 2

A financial instrument where performance is linked to the correlation over a certain period between an oil company's share price and the level of a commodities index.

➔In this case, the investor must be able to anticipate changes in the correlation between a share and the underlying index, which generally requires a high level of expertise.

Example 2a

A financial instrument that is indexed on the VSTOXX® index that exposes the investor to a loss at maturity of 50% of the capital invested if the index declines by 50%.

➔ The underlying asset for the financial instrument is a EURO STOXX 50® volatility index, which is difficult for a retail client to understand.

Criterion 3: payoff profile depends on the simultaneous occurrence of several conditions across two or more asset classes.

The return on some financial instruments depends on the simultaneous occurrence of several conditions across different asset classes (equities, fixed income products, real estate, etc.), which makes it hard for clients to grasp the market scenarios they should be anticipating. This is particularly the case where the occurrence of one condition applies solely to the principal amount while the occurrence of a second condition applies solely to any coupon.

Example 3

A financial instrument that offers the average performance of the CAC 40® index over a five-year period at maturity, plus or minus an annual coupon payment that depends on the performance of the bond market:

i) For each year where the CMS 10 year® rate is more than 55 bp higher than the CMS 2 year® rate, and the CAC 40®

index posts a gain, a 4% coupon is paid at maturity.

ii) For each year where the CMS 10 year® rate is less than 20 bp higher than the CMS 2 year® rate and the CAC 40® index posts a loss, the final return is reduced by 1%.

➔ Two asset classes determine the ultimate performance of this financial instrument: equities and fixed income. It is difficult, if not impossible, for retail clients to grasp the market scenarios that they should be anticipating.

Example 3b

A financial instrument where the amount of the coupon depends on the performance of the Euro Stoxx index while repayment of the principal depends on the occurrence of an event of default in a basket of ten bonds:

i) Investors receive an annual coupon of 5%;

ii) At maturity,

- investors receive a coupon of 6% if the Euro Stoxx index has remained stable or risen relative to its initial position;
- investors receive the full amount of their initial capital provided that none of the ten bonds in the basket has been the subject of a credit event;
- where one or more credit events have occurred, investors incur a capital loss equal to 10% of the par value of each bond that has been the subject of a credit event.

➔ The performance of this financial instrument is ultimately determined by two different conditions relating to different asset classes: repayment of the principal is determined by the basket of bonds and payment of the coupon is determined by the performance of the Euro Stoxx index. It is difficult, if not impossible, for retail clients to grasp the macroeconomic market scenarios they should be anticipating.

3.2 Risk that clients will not understand the financial instrument being offered

Criterion 4: number of mechanisms in the formula for calculating the financial instrument's payoff

Understanding risk requires a good grasp of the steps used to calculate the product's return and the structuring mechanisms or the underlying asset class. If there are more than three calculation mechanisms for determining the overall return on the product directly or through an underlying structured index, it is difficult, or even impossible, for investors to grasp the "bet" that they are making. They cannot understand the mechanisms that result in a loss or a gain under a given market scenario.

Example 4

Product with the following payoff profile at maturity:

i) The **average quarterly performance** over 5 years of a **strategy index** that overweights the 20 highest-performing CAC 40® stocks in the previous month and underweights the 20 lowest-performing stocks.

ii) If, at a set quarterly date, the index is up by more than 10% over the previous quarter, **a 6% coupon or bonus** will be paid at maturity.

iii) If at a set quarterly date, the index is **down by more than 30%** from its starting level, then the product is liquidated (or terminated) and redeemed before maturity. In this case, the full decline in the index is subtracted from the initial capital outlay, and any bonuses acquired in the previous quarters are added.

➔High risk of misunderstanding. Four different mechanisms come into play in the calculation of the final return: the effect of averaging, a strategy that is intrinsic to the underlying index, a bonus for exceeding an upper bound and a loss for exceeding a lower bound.

<u>Examples of strategies used as structuring mechanisms:</u>

- an algorithm underlying a proprietary strategy index;
- averaged performances;
- cap/floor effects;
- protection that is knocked out when a decline exceeds a downside bound;
- “memory” effect;
- crystallisation of gains.

4. Position

The financial instruments covered by the Position may, by their nature, carry a risk that retail clients may fail to understand the potential losses to which they may be exposed, or even that the instruments in question may be unintelligible to retail clients.

Structured CIS and AIF and complex debt securities (including in particular complex EMTNs):

– offering capital protection at maturity of less than 90% of the capital invested[21] and
– meeting at least one of the criteria defined above

carry a risk of inappropriate marketing such that **it will be particularly difficult** for them to comply with applicable legislative and regulatory requirements on marketing.

The situation is, however, different for relevant financial instruments whose performance is sensitive to extreme scenarios (Criterion 1) where they are properly presented (i.e. as an alternative to a corresponding investment in the underlying, accompanied by a description of situations in which the maximum risk would arise).

[21]For financial instruments offering partial capital protection at maturity, marketing materials must clearly highlight the risk of capital loss, stating that such losses “may be up to X%”.

Apart from in this latter situation:

(a) As regards promotional information, **it will be particularly difficult** to comply with the provision under which "all information, including promotional information, […] shall be presented in a way that is accurate, clear and not misleading"[22], given the characteristics of these structured financial instruments.

Consequently, promotional communications relating to a public offering or admission to trading on a regulated market, including where the prospectus has already been passported, as well as marketing materials pertaining to harmonised French and foreign structured CIS/AIF, must comply with the instructions given in Annex 1 to this Position. However, there is no need to include this information for private placements.

(b) Furthermore, as regards the marketing of relevant structured financial instruments (i) with a par value or initial investment of less than €100,000 (or the equivalent value in foreign currency) or (ii) with a par value or initial investment of at least €100,000 (or the equivalent value in foreign currency) where such marketing is for portfolio diversification purposes, **it will be particularly difficult** to comply with the following requirements:

- the requirement applicable to investment services providers to issue information that enables investors to have "a reasonable understanding of the nature […] of the specific type of financial instrument being offered and the risks pertaining thereto, so that clients can make informed investment decisions"[23] and to provide information that can be understood "by an average investor in the category to which it is directed or by which it is likely to be received, [and which] does not distort, minimise or obscure certain key factors, statements or disclaimers"[24];

- the requirement applicable to financial investment advisers to formalise their advice in a report supporting their different proposals, "their benefits" and the "risks they entail"[25];

- the requirement applicable to direct marketers of banking and financial services to disclose, "in a clear and comprehensible manner, the information […] needed" by the person solicited to reach a decision[26];

- the requirement applicable to investment services providers and financial investment advisers to[27]:

    1. "recommend suitable financial instruments" in respect of investment advice services provided by investment services providers and financial investment advisers;

    2. check that "the products or services offered to clients" are appropriate in respect of third party order execution services and third party order reception and transmission services provided by investment services providers.

(c) Finally, investment services providers, financial investment advisers and direct marketers of banking and financial services do not fall into categories (a) or (b) above when they market the structured financial instruments set out in paragraph 3 and:

- the par value or initial investment is less than €100,000 (or the equivalent value in foreign currency) and

[22] Articles L. 533-12 of the Monetary and Financial Code and 314-10 and 325-5 of the AMF General Regulation. V. Articles 19, 2 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 and Article 27 of Commission Directive 2006/73/EC of 10 August 2006.
[23] Articles L. 533-12 of the Monetary and Financial Code and 314-18 and 314-33 of the AMF General Regulation. V. Articles 19, 3 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 and Articles 28-34 of Commission Directive 2006/73/EC of 10 August 2006.
[24] Article 314-11 of the AMF General Regulation. V. Article 27 of Commission Directive 2006/73/EC of 10 August 2006.
[25] Article 325-7 of the AMF General Regulation.
[26] Article L. 341-11 of the Monetary and Financial Code.
[27] Articles L. 533-13 of the Monetary and Financial Code and 314-43 et seq. of the AMF General Regulation, together with Article L. 541-4 of the Monetary and Financial Code. V. Articles 19, 4 and 5 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 35 and Articles 35 and 36 of Commission Directive 2006/73/EC of 10 August 2006.

- such marketing is for the purposes of diversifying the portfolios of retail clients. This diversification requirement must be assessed in light of the total amount invested in financial instruments. The marketing of these instruments must not result in a client's financial assets being too heavily concentrated in the instruments concerned.

In such cases, however, investment services providers, financial investment advisers and direct marketers of banking and financial services must ensure that they fulfil their obligations as set out in paragraph 2.

Annex 1 – Language to included in advertisements and marketing materials

Types of financial instruments	*Highly complex structured financial instruments with a high risk of mis-selling* (instruments referred to in paragraph 3) Enhanced vigilance approach	*Complex structured financial instruments with a possible risk of mis-selling* (instruments referred to in paragraph 1) Vigilance approach	*Financial instruments using standard management techniques that do not, in principle, involve a high risk of mis-selling* (all other financial instruments) Standard approach
Submission of marketing materials to the AMF	Article 212-28 of the AMF General Regulation stipulates that advertisements for public offerings or admissions to trading on a regulated market of debt securities, regardless of form or method of dissemination, shall be submitted to the AMF before being disseminated. As regards structured CIS/AIF or AIF referred to in Article L. 214-35 of the Monetary and Financial Code (ARIA funds) using specific investment strategies such as portfolio insurance, long/short or replication of an index, Instructions 2011-19 and 2011-20 stipulate that marketing materials must be submitted to the AMF as part of the authorisation procedure. Furthermore, AMF Instruction 2011-19 stipulates that the marketing materials in question must be submitted to the AMF for coordinated European CIS/AIF marketed in France.		
Language that must appear in advertisements and marketing materials	**In very visible print:** *"The offering prospectus for the proposed complex debt security has been approved by [name of regulator].* ***However, since the AMF considers this product too complex to be marketed to retail clients, it has not examined the marketing materials.*** *These materials are produced by [name of responsible entity or entities].* *"The proposed CIS/AIF has been authorised by [name of regulator].* ***However, since the AMF considers this product too complex to be marketed to retail clients, it has not examined the marketing materials.*** *These materials are produced by [name of responsible entity or entities].*	If the advertisement mentions the fact it has been submitted to the AMF, the following language must be inserted: *"The offering prospectus for the proposed complex debt security has been approved by [name of regulator]. These materials are produced by [name of responsible entity or entities].* *"The proposed CIS/AIF has been authorised by [name of regulator]. These materials are produced by [name of responsible entity or entities].* If the advertisement does not mention the fact that it has been submitted to the AMF, then no specific language is required under the terms of this Position.	No specific language is required under the terms of this position[28].

[28] As a general rule, operators should refer to the various best practices guides for the drafting of advertisements published by the AMF.

Annex 2 – Decision tree

If

a financial instrument concerned mentioned in paragraph 1

- offers protection at maturity for less than 90% of the capital invested

And

- fulfils one or more of the four criteria set out in paragraph 3 (NB: Criterion 1 with regard to the sensitivity of return to extreme scenarios has not been fulfilled if (i) the product is presented as an alternative to a corresponding investment in the underlying asset and (ii) if the situations in which the maximum risk occurs are explained)

Then

- it will be particularly difficult to comply with the laws and regulations applying to marketing;
- in the case of a public offering or admission to trading on a regulated market, advertisements and marketing materials must include the language in Annex 1 ("enhanced vigilance" approach).
- ***Exception:*** *if the face value or the initial subscription amount is greater than EUR 100,000 with sufficient diversification:*
    - *investment services providers, financial investment advisers and direct marketers of banking and financial services must ensure that they comply with their obligations set out in detail in paragraph 2.*
    - *in the case of subscriptions to a public offering or admission to trading on a regulated market, advertisements must include the language in Annex 1 ("vigilance" approach).*

Otherwise

(meaning, if a financial instrument concerned mentioned in paragraph 1

- *offers protection for 90% or more of the capital invested*

Or

- *does not fulfil any of the 4 criteria defined in paragraph 3)*

- investment services providers, financial investment advisers and direct marketers of banking and financial services must ensure that they comply with their obligations set out in detail in paragraph 2;
- in the case of a public offering or admission to trading on a regulated market, the brochure must include the language in Annex 1 "vigilance" approach.