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ESMA Issues New Opinion on Complex Product Sales Practice

ESMA's recently published opinion on MiFID practices for firms selling complex products focuses on ensuring that firms take appropriate measures to protect investors from additional risks. The opinion defines what ESMA considers to be a complex product and discusses aspects of compliance—internal controls, product suitability and appropriateness assessments, related disclosures and communications, and sales monitoring—to which firms should give enhanced attention.

The European Securities and Markets Authority (ESMA) recently published an opinion on practices under the Markets in Financial Instruments Directive (MiFID[1]) for firms selling complex products. ESMA issued this opinion on February 7, 2014 to give an indication of when a product might be a "complex" one and to remind national supervisors and investment firms about the degree of importance it attaches to the full satisfaction of those requirements, particularly in connection with sales to retail investors. The primary focus of the opinion is ensuring that firms selling complex products take appropriate measures to protect investors from additional risks. ESMA believes that, although existing standards should be adequate to accomplish this result, firms' compliance with the selling practices required by MiFID when selling complex products may have fallen short. In particular, ESMA believes that complex products are being sold that are increasingly difficult to understand and are being sold using platforms that make it increasingly difficult for investors to inform themselves adequately.

ESMA begins its opinion by first defining what it considers to be a complex product; it then proceeds to discuss aspects of compliance that should be given enhanced attention.

[1] EU Directive 2004/39/EC

ESMA believes that products should generally be considered "complex" when they have one or more of the following characteristics:

1. They are derivatives, or embed a derivative;
2. They are made up of one or more underlying financial instruments that are difficult to value, or are combined in such a way so as to make it difficult to assess the risks involved and the likely performance scenarios;
3. They use opaque indices with few data points that are, for example, created by the product manufacturer, rather than using standard market indices;
4. They have a fixed investment term of a number of years with barriers to exit (that are not clearly explained) regardless of whether that is due to the lack of a secondary market, or significant penalties or losses on early exit;
5. They have returns/pay-off structures involving multiple variables or complex mathematical formulas; or
6. They include capital protection provisions that may be conditional or partial, or that can be withdrawn on the occurrence of certain events.

The aspects of a firm's compliance program that appear to ESMA to be most worthy of attention are:

- The firm's organization and internal controls;
- Its assessment of the suitability and the appropriateness of certain products;
- Its disclosures and communications in relation to products; and
- The manner in which it monitors compliance of the sales functions.

The assessment of internal controls should consider whether conflicts of interest arise in the sale of complex products, especially when the selling entity is the issuer or is acting as a counterparty in the transaction. The compliance function should consider if incentives relating to the product create conflicts of interest and should specifically assess whether incentives (i.e. inducements or remuneration) are more lucrative for complex products than for those of more standard investments.

In evaluating suitability of products for their clients, firms should assess and establish:

1. The client's investment objectives and attitude toward risk, especially for investments involving leverage and those linked to highly volatile asset classes; and
2. The client's time horizon for the investment, especially in light of the product's possible lack of liquidity. For products with fixed terms, firms should determine whether the retail client will require access to any of the funds relating to the complex product during the term of the investment.

In determining appropriateness, firms should assess the knowledge and experience of the client in the context of the complexity of the product and the risks involved.

Firms selling complex products are required to provide disclosure that is “fair, clear and not misleading,” including, in particular, as to (i) costs and charges applicable to the product and (ii) potential consequences of seeking to sell or exit early.

In performing their supervisory duties, national supervisory authorities should ensure that the compliance function of a firm takes a risk-based approach in determining the appropriate focus of the monitoring and advisory activities of the sales function. The more complex the product, the more scrutiny the firm’s compliance function should apply. In particular, therefore, supervisory authorities should monitor whether a firm has identified the sales of complex products as an area of the firm’s investment services that requires close scrutiny. This compliance risk assessment should be performed regularly and be well documented to ensure that the focus and the scope of such monitoring remains valid.

It can be expected that ESMA’s recommendations will have a significant impact on the selling practices used for complex financial products as well as on the structuring of firms’ compliance function.

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