

Scope of Financial Instruments under MiFID

**Treatment of Transferable securities,
Money market instruments, Derivatives,
Forex transactions, Financial contracts for
differences**

TAIEX Workshop on MiFID, Ankara,
27.09.2010-28.09.2010

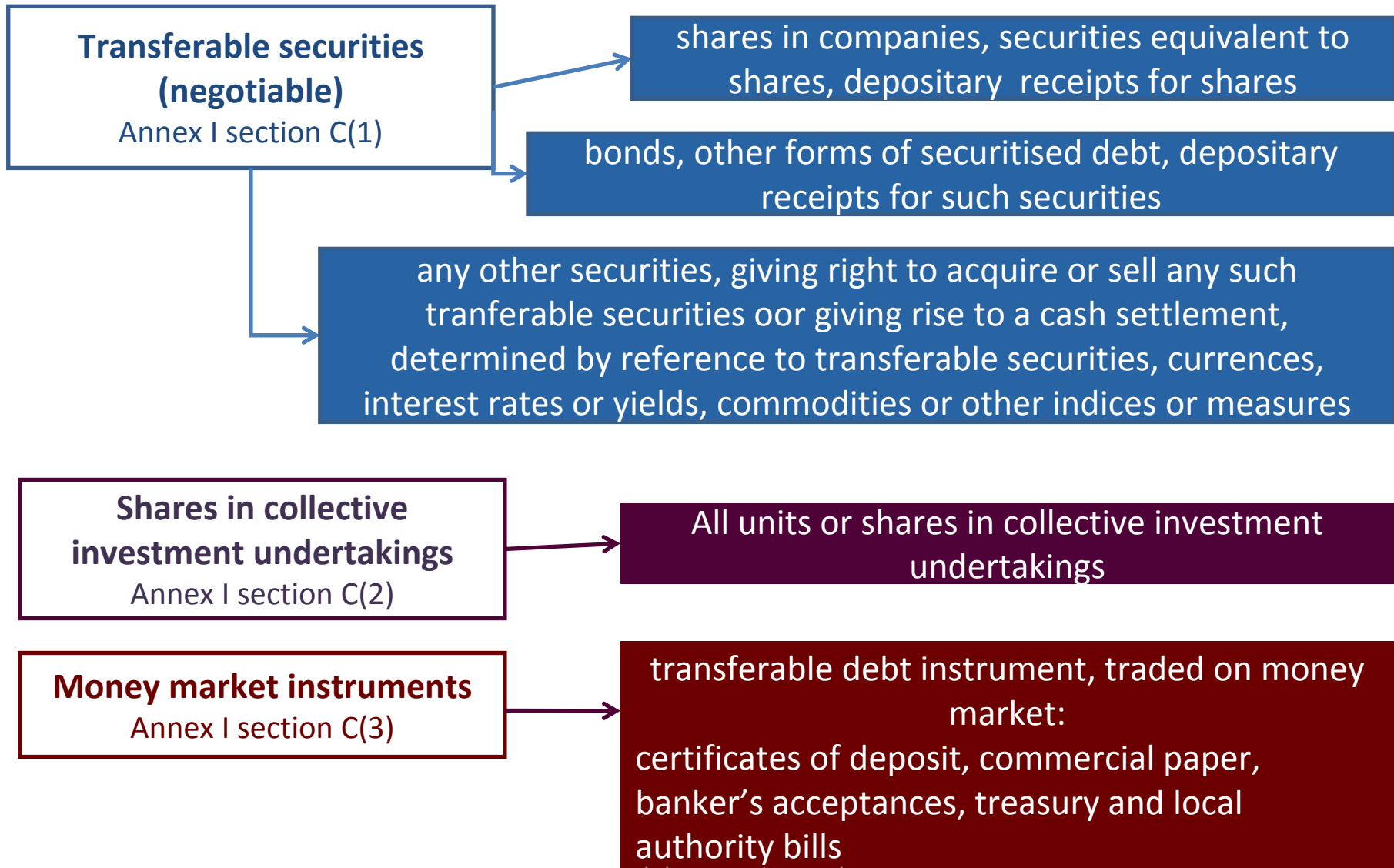
Agenda

- I. Financial instruments under MiFID
- II. Treatment of financial instruments: complex and non-complex
- III. Consequences of treatment as complex financial instruments on different aspects of investment services

Financial instruments under MiFID

- no general definition of a financial instrument in MiFID
- scope of financial instruments is defined by enumeration – list of FI is provided in Section C of Annex I of MiFID

I. Scope of FI under MiFID



Scope of FI under MiFID

Derivatives

Annex I section C(4)-C(7)

options, futures, swaps, forward rate contracts and any other derivatives

related to

securities,
currencies, interest
rates/yields, other
derivatives, financial
indices or financial
measures which
may be settled
physically or in cash
Annex I Section C(4)

commodities
that
must be settled in
cash or may be
settled in cash at
the option of one
of the parties
Annex I Section C(5)

commodities
that can be
physically settled
provided that
they are traded
on a regulated
market and/or an
MTF
Annex I Section C(6)

commodities
that can be
physically settled,
not mentioned in
C(6), not being
for commercial
purposes, which
have
characteristics of
other derivatives
Annex I Section C(7)

Scope of FI under MiFID

Derivatives

Annex I section C(8)-C(10)

**instruments for
the transfer of
credit risk**

Annex I Section C(8)

**financial contracts for
differences**

related to

**MiFID instruments,
currencies, interest rates
or other financial indices**

Annex I Section C(9)

**options, futures, swaps,
forward rate contracts and
any other derivatives**

related to

**climatic variables,
freight rates, emission
allowances or inflation rates or
other official economic statistics
(cash settlement option) and **assets,
rights, obligations, indices** and
measures not otherwise mentioned**

Annex I Section C(10)

Scope of FI under MiFID

Transactions/contracts, which form in point of fact financial instrument listed in Section C of Annex I of MiFID, should be treated as financial instruments under MiFID (i.e. so called marginal FOREX trading / rolling FX spot contracts take form of CFD)

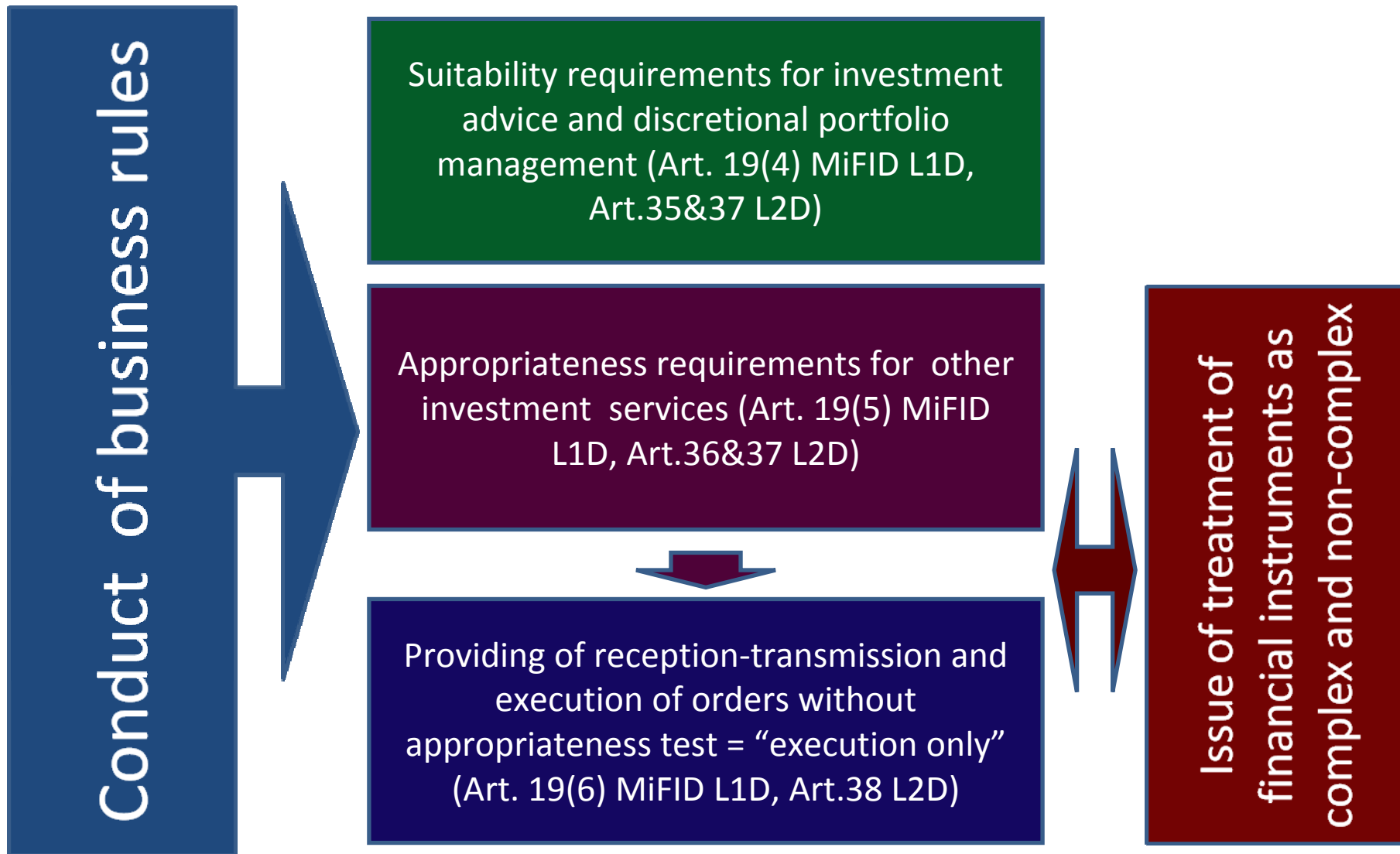
Latvian experience (scope)

From the point of view when having definition of financial instrument in national law:

- practical difficulties when applying certain restrictions provided in other laws (i.e. defined limits for collective investment undertakings);
- risk to spread MiFID provisions to non-MiFID products.



II. Treatment of financial instruments



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Ref: CESR published (2009) CP and policy statement on complex and non-complex FI

Complex and non-complex FI

Which instruments are complex and non-complex?

Under MiFID, the following types of MiFID financial instruments are automatically non-complex:

- – shares admitted to trading on a regulated market or in an equivalent third country market;
- – money market instruments, bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative);
- – UCITS; and
- – “other non-complex financial instruments”.

Shares

MiFID does not define term “shares”. Definition of ‘transferable securities’ in MiFID Art. 4(1)(18)(a) states:

“shares in companies and **other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares”**



Automatically non-complex:

shares in companies included preference shares that do not embed a derivative



To be assessed against criteria, provided in MiFID Implementing Directive Art. 38:

- depositary receipts for shares;
- Shares not admitted to trading on a regulated market;
- Shares admitted to trading on a third country market;
- “stapled securities”;
- Shares in non-UCITS funds.

Money market instruments

MMI that do not embed derivative, are non-complex

➤ Treasury bills	securities issued by any central, regional or local authority, a central bank of a Member State, EU, ECB, EIB, a non-Member state or a member of federation)
➤ Certificate of deposit	if not negotiable on the capital market, then excluded from MiFID as instrument of payment
➤ Commercial paper	unsecured promissory note with fixed maturity (≤ 9 months) and variable interest rates

Bonds

Bonds that do not embed derivative, are non-complex

➤ Traditional bonds	bond-holder is in effect lender to the issuer
➤ Covered bonds	traditional bonds with enhancement
➤ Subordinated bonds	traditional bonds with specific repayment regime

Depository receipts in respect of bonds treated the same way as for shares – to be assessed against criteria under Art. 38 MiFID Level 2

Bonds

Bonds that embed derivative, are complex.

No definition of bonds that embed a derivative in MiFID.

IAS 39, §10 defines an embedded derivative as “a component of a hybrid (combined) instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a standalone derivative”.

Bonds

Examples of bonds, MMI and other forms of securitised debt embedding a derivative

➤ Credit linked notes (CLN)

➤ callable & puttable bonds

➤ Structured instruments whose performance is linked to the performance of a bond index

➤ Structured instruments whose performance is linked to the performance of a basket of shares with or without active management

➤ Structured instruments with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares with or without active management

➤ Convertible bonds

➤ Asset backed securities

➤ Exchangeable bonds

➤ Structured covered bonds

UCITS

- No special meaning of the term “UCITS” in MiFID. The reference captures investments in a collective investment undertaking which is constituted according to the UCITS Directive (Directive 85/611/EC).
- UCITS are non-complex by definition regardless of the underlying instruments.
- Non-UCITS has to be assessed against criteria of Art. 38 of MiFID L2D – none are automatically complex.

UCITS

What can make non-UCITS complex?

- ✓ not authorised or regulated in accordance with UCITS Directive.
- ✓ non-UCITS can be more flexible than UCITS with regards to the assets they can hold and way they spread risk and use leverage.
- ✓ Investing in derivatives does not automatically make non-UCITS complex.

Other non-complex financial instruments

are those that meet all the following four conditions:

- (i) not a **derivative** or any other **security giving the right** to acquire or sell 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 (Art. 4(1)(18)(c), points (4) to (10) of Section C of Annex I to MiFID);
- (ii) **frequent opportunities** to dispose of, redeem, or otherwise 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;

Other non-complex financial instruments

- (iii) it does not involve any actual or potential **liability** for the client that **exceeds the cost** of acquiring the instrument;
- (iv) adequately **comprehensive information** on its characteristics is publicly available and is likely to be readily understood so as to enable the average retail client to make an informed judgment as to whether to enter into a transaction in that instrument.

Other products

- Deposit with an embedded derivative that has the potential of reducing the initial capital invested as a financial instrument under MiFID;
- Other securities giving the right to acquire or sell a transferrable security or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measure, i.e.
 - Warrants
 - Covered warrants
 - Financial contracts for differences, incl. Exchange traded commodities (that are contracts for difference and financial ‘spread bets’)

Consequences of treatment as complex financial instruments, some practical issues

Practical issue: client's information

Query: can firm simply rely on client's provided data on his/her knowledge and experience?

The position of FCMC: when evaluating client's ability to understand the nature and risks related to investment (reading of client's data), differentiated approach is justified:

↳ the FI is non-complex ⇒ no additional information may be needed

↳ the FI is complex ⇒ it's likely that more additional information may be requested

Practical issue: correlation of knowledge and experience

Case: some firms assume that a single trade by client is enough to conclude that client has sufficient knowledge.

The position of FCMC: when evaluating client's ability to understand the nature and risks related to investment (reading of client's data), differentiated approach can be justified:

- ↳ is the FI so simple and straight forward (non-complex) ⇒ such assumption may be justified
- ↳ is the FI complex ⇒ it is ambiguous to conclude that client has sufficient knowledge

Practical issue: client's best interests

Case: client has not provided information on his/her knowledge and experience or information provided leads to conclusion, that deal won't be appropriate for the client.

According to appropriateness requirements the firm cannot proceed with the deal without warning. But different approach could be justified: i.e. in case of risky complex products such as oil futures it might be that provision to act in the best interests of client requires from the firm not to proceed with the deal even if client requests it.



Practical issue: best execution

Complex FI: structured products, CFDs, spread bets

- These products are usually principal trades so best execution may not arise
- However, if best execution does arise, then there are usually proxies or reference prices for the components of the product – after all, this is the firm's approach to pricing
- in case of CFDs, for retail customers, it is likely that they rely on the firm and so best execution will apply and the firm's price will usually be linked to the underlying market price

Thank you!

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