CNMV APPROVES A CIRCULAR ESTABLISHING NEW WARNINGS ON FINANCIAL INSTRUMENTS CONSIDERED ESPECIALLY COMPLEX

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- The Circular reinforces the obligation to issue warnings in relation to very specific financial instruments, such as CFDs, contingently convertible or subordinated bank bonds or certain structured bonds referenced to illiquid securities or to credit events.
- It also reinforces transparency on the prices at which retail investors acquire or sell financial products (when they differ significantly from their fair value).
- The objective is to increase retail investor protection and improve transparency in the distribution of financial instruments.

The National Securities Market Commission (CNMV) has approved Circular 1/2018 on warnings related to financial instruments.

The new Circular establishes that investors must state the following in writing: "*This product may be difficult to understand. CNMV considers that, in general, it is not appropriate for retail investors*", in the contractual documentation corresponding to the following financial products:

- CFDs and binary options
- Complex financial instruments classed as own capital of credit institutions, such as convertible debt, perpetual debt and, in certain cases, subordinated debt
- Certain complex structured products and OTC derivatives (referenced to illiquid securities or to credit events, or with a high speculative purpose in the case of OTC derivatives).

In addition, the Circular obliges credit institutions and investment firms to warn their clients about the following:

- The risk of losses in securities market instruments within the scope of the bail-in tool.

- The existence of significant differences between the effective amount at which the purchase or sale will be made with the client and the estimated current value of the product, a situation in which the inherent costs for the investor are highlighted (certain fixed income instruments, structured contracts and OTC derivatives, etc.).

The purpose of this Circular is to increase the protection of retail investors by reinforcing their informed consent and improving information transparency in the distribution of financial instruments.

The Circular establishes the content with **three standard warnings**:

1. Particular complexity warning. In the opinion of CNMV, certain highly complex instruments with a high risk level are not appropriate, in general, for widespread circulation among the retail public. These instruments include:

    - Complex financial instruments that, under the solvency regulations of credit institutions, are classed as own capital, such as, for example, convertible debt, perpetual debt or, in certain cases, subordinated debt.

    - Complex structured products (bonds, financial contracts or CIS), in which the amount to be reimbursed is less than 90% of the initial investment and, in addition: have underlying assets that are not traded on markets in which prices are disseminated daily, or are linked to the occurrence of events related to credit risk (credit-linked notes).

    - OTC derivatives, with no hedging purpose, with underlying assets that are not usually invested by retail investors or that are by nature highly speculative.
    - Other highly complex instruments such as binary options or CFDs.

In these cases, the informed consent is reinforced by obliging companies to obtain the following **handwritten statement from the client**:

> ***Handwritten statement from the client:***
> *"Product that is difficult to understand. CNMV considers that, in general, it is not appropriate for retail investors".*

This handwritten statement will accompany the warning signed by the client:

> ***Warning:***
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> *"You are about to purchase a product that is not simple and may be difficult to understand: (the product must be identified). The National Securities Market Commission (CNMV) considers that, in general, its acquisition by retail clients is not appropriate due to their complexity. However, ZZZ (name of the entity) has assessed your knowledge and experience and considers that it is appropriate for you".*
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> A second paragraph will be added in cases where the retail client can assume financial obligations for an amount greater than the cost of acquisition of the instrument:
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> *"This is a leveraged product. You should be aware that the losses may be greater than the amount initially paid for its purchase."*

2. <u>Warning on equity or liability instruments within the scope of the bail-in tool</u>. The recovery and resolution regulations of credit institutions and investment firms consider, as a possibility, the implementation of the bail-in tool. In a resolution scenario, retail investors could incur significant losses. The warning, for which the investor's signature must be sought, identifies the shares or debt instruments that may potentially be affected by such situations.

> ***Warning:***
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> *"You are about to purchase a product that is an equity or liability instrument within the scope of the bail-in tool: (the product must be identified). In the event of the resolution of the issuer of such financial instrument (a process applicable when the issuer is unviable or it will foreseeably be so in the near future, and for reasons of public interest and financial stability it is necessary to prevent the liquidation of its assets in bankruptcy proceedings), this product could be converted into shares or its principal could be reduced and, consequently, its holders would incur losses on their investment for that reason."*

3. **Warning about significant differences with respect to the instrument's value**. Retail clients must be expressly warned when the costs inherent in certain financial instruments on which they carry out purchase or sale transactions are significant and not easily recognisable. These instruments would include fixed income instruments when the counterparty is the entity itself, structured financial contracts and certain OTC derivatives.

   The warning, for which the investor's signature must be obtained, must be provided when the total cost of the instrument (difference between the actual amount and the current value estimate) is greater than 5% in total, or 0.6% multiplied by the number of years remaining until its maturity.

> ***Warning:***
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> *"According to the approximate estimate of the current value of the financial instrument YYYY (the financial instrument must be identified) made by ZZZ (name of the entity that made the estimate), and considering all the costs of this transaction, you are incurring an approximate total cost of X% (the percentage must be indicated) of the current estimated value of this instrument/of the notional amount of this instrument (the option corresponding to the type of instrument in question will be included)".*

The processing of this Circular includes, inter alia, reports drafted by the European Commission, the State Council and CNMV's Advisory Committee.

ESMA is considering possible prohibitions or restrictions on some of the products affected by the Circular (CFDs and binary options). Once these measures have been adopted at European level, CNMV will convey to the sector such guidelines as may be necessary in order to align the application of the Circular with the content of such measures.

The new Circular will enter into force three months after its publication in the Official State Gazette.

For further information:
CNMV Communications Office
Tel.: 91 5851530
www.cnmv.es
comunicacion@cnmv.es
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