

## AMF Position No 2010-05 - 15 October 2010

### Marketing of complex financial instruments

**References:** Article L. 533-11 et seq. and Article L. 541-1 et seq. of the Monetary and Financial Code; Article 314-1 et seq. and Article 325-3 et seq. of the AMF General Regulation.

#### Background

The AMF, which is responsible for protecting savings invested in financial instruments sold to the public and admitted to trading on a regulated market or in any other public offerings<sup>1</sup>, has decided to publish a position on the direct marketing of complex products. It has been prompted to do so by the informational asymmetries between retail investors and producers/suppliers of structured funds and complex debt securities (notably complex EMTNs), the difficulties experienced by retail clients in understanding these products, and the risk that entities marketing them may fail to comply with their obligations.

The ACP<sup>2</sup>, which is charged with protecting clients of insurance entities, scrutinises such financial instruments when used as investment vehicles for life insurance policies. Consequently, the ACP 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:

- underlines the responsibility of investment services providers (even when acting through a tied agent), financial investment advisers, and direct marketers of banking and financial services with regard to the information provided to retail investors about structured funds and complex debt securities (notably 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. Scope of the AMF position

##### a) 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;
- equivalent foreign funds<sup>3</sup>;

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<sup>1</sup> Article L. 621-1 of the Monetary and Financial Code.

<sup>2</sup> Autorité de contrôle prudentiel 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.

<sup>3</sup> Structured UCITS are defined in Article 36 of Commission Regulation (EU) 583/2010 of 1 July 2010 Implementing Directive 2009/65/EC.

- 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.

#### **b) Situations concerned**

The AMF position concerns marketing, defined as the presentation of a financial instrument through different means (advertising, direct marketing, placement, advice, etc.) by an investment services provider<sup>4</sup>, a financial investment adviser, or a direct marketer of banking or financial services<sup>5</sup> 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.

#### **c) 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<sup>6</sup> 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"<sup>7</sup>. These entities could also be liable to sanctions imposed by the AMF Enforcement Committee for non-compliance<sup>8</sup>.

The position concerns retail investors<sup>9</sup>. It does not apply to marketing to professional investors and/or eligible counterparties.

<sup>4</sup> 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).

<sup>5</sup> For products subject to direct marketing.

<sup>6</sup> Or their tied agent(s).

<sup>7</sup> Article L. 341-4-III of the Monetary and Financial Code.

<sup>8</sup> Article L. 621-15, II of the Monetary and Financial Code.

<sup>9</sup> Article L. 533-16 of the Monetary and Financial Code.

**Laws and regulations**      **2. Producer’s and distributor’s obligations in the marketing of the financial instruments in question**

Articles L. 533-1, L. 533-11, L. 533-13, L. 533-16 and L.541-4 of the Monetary and Financial Code

**a) 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

Articles 314-3, 314-11, 314-18, 314-36 and 314-43 and the following articles of the AMF General Regulation

Investment services providers<sup>10</sup> are required to “act honestly, fairly and professionally in accordance with the best interests of its clients” and financial investment advisers<sup>11</sup> 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.”<sup>12</sup>

“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<sup>13</sup>.

“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.”<sup>14</sup>

Assessment of the suitability and appropriateness of the investment service

Investment services providers must also do the following for their retail clients<sup>15</sup>:

<sup>10</sup> 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.

<sup>11</sup> Article L.541-4 of the Monetary and Financial Code.

<sup>12</sup> Article 314-11 of the AMF General Regulation. See Article 27 of Directive 2006/73/EC of the Commission of 10 August 2006.

<sup>13</sup> 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.

<sup>14</sup> Article 314-36 of the AMF General Regulation. See Article 31 of Directive 2006/73/EC of the Commission of 10 August 2006.

<sup>15</sup> 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.

- 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<sup>16</sup>.

#### 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<sup>17</sup>, even if the prospectus has already been passported<sup>18</sup>. The same applies to advertisements for French and European structured UCITS<sup>19</sup>.

Article 212-  
28 of the  
AMF  
General  
Regulation

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<sup>16</sup> Article L. 541-4 of the Monetary and Financial Code.

<sup>17</sup> Article 212-28 of the AMF General Regulation.

<sup>18</sup> 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).

<sup>19</sup> AMF Instruction 2005-01.

**Position b) Producers' and distributors' obligations**

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;
- consider the legal framework used to structure the product and, more specifically, any investor protection rules, other than the disclosure rules, (presence of a depository, 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 investors.

Furthermore, advertisements about the financial instruments concerned relating to a public offering or admission to trading on a regulated market must include the language in Annex 1, as appropriate, along with marketing materials relating to French and European structured UCITS, even when the prospectus has already been passported.

### 3. Determining objective criteria for assessing mis-selling risk

The AMF, in keeping with the ACP 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.

#### **a. 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).

#### **CRITERION 1: Poor presentation of the risks and payoff profile of the product**

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<sup>20</sup>. 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.

#### **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.

<sup>20</sup> This type of product may be exempted from the “enhanced vigilance” approach if presented appropriately (see position below).

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<sup>®</sup> 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<sup>®</sup> 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.

**Example 3**

A financial instrument that offers the average performance of the CAC 40<sup>®</sup> 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<sup>®</sup> rate is more than 55 bp higher than the CMS 2 year<sup>®</sup> rate, and the CAC 40<sup>®</sup> index posts a gain, a 4% coupon is paid at maturity.
- ii) For each year where the CMS 10 year<sup>®</sup> rate is less than 20 bp higher than the CMS 2 year<sup>®</sup> rate and the CAC 40<sup>®</sup> 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.

**b. 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 three or more 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<sup>®</sup> 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.

Examples of strategies used as structuring mechanisms:

- 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 nature of the financial instruments covered by this position may give rise to the risk that retail investors will fail to understand the potential losses or even to understand the product.

Structured funds and complex debt securities, such as complex EMTNs:

- offering protection at maturity for less than 90% of the capital invested<sup>21</sup>, and
- fulfilling at least one of the criteria defined above

present such strong mis-selling risks that it would be especially difficult for them to comply with the applicable laws and regulations on marketing.

However, this is not the case for the financial instruments concerned, where performance is sensitive to extreme scenarios (Criterion 1), if they are presented appropriately as an alternative to a corresponding investment in the underlying asset, and the situations where maximum risk is incurred are presented.

Except in this situation:

a) it would be **particularly difficult** for advertisements to comply with the provision that states “all information, including advertising, shall present content that is accurate, clear and not misleading”<sup>22</sup>, in view of the characteristics of these structured financial instruments.

Consequently, advertisements relating to a public offering or admission to trading on a regulated market, even when the prospectus has already been passported, along with marketing materials relating to French and European structured UCITS, must include the language in Annex 1 to this position. By contrast, these provisions do not apply to private placements.

<sup>21</sup> In the case of financial instruments offering partial protection of capital at maturity, the advertisements must clearly state the risk of capital loss “of up to X%”.

<sup>22</sup> Article L. 533-12 of the Monetary and Financial Code, Articles 314-10 and 325-5 of the AMF General Regulation. See Article 19, 2 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 and Article 27 of Directive 2006/73/EC of the Commission of 10 August 2006.

b) Furthermore, with respect to marketing the structured financial instruments concerned i) where the face value or the initial subscription amount is less than EUR 50,000 (or the equivalent in another currency) or ii) where the face value or the initial subscription amount is EUR 50,000 or more (or the equivalent in another currency), and the product is not being marketed for portfolio diversification purposes, it would be **particularly difficult** to comply with the obligations:

- incumbent on investment services providers to provide information that enables investors “to understand the nature and risks of (...) the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis”<sup>23</sup> and to provide information that is understandable “by an average member of the group to whom it is directed, or by whom it is likely to be received [and that does not] disguise, diminish or obscure important items, statements or warnings”<sup>24</sup>.
- incumbent on financial investment advisers, to formalise their advice “in a written report giving reasons for the adviser’s different proposals and stating the attendant advantages and risks”<sup>25</sup>;
- incumbent on direct marketers of banking and financial services to provide the prospect with “clear and understandable information to make his decision”<sup>26</sup>;
- incumbent on investment services providers and financial investment advisers to<sup>27</sup>:
  1. “recommend suitable financial instruments” in the case of financial investment advice provided by investment services providers and financial investment advisers;
  2. to ensure that “the services and products offered to clients” are appropriate for them in the case of execution-only services and order reception and transmission services provided by investment services providers.

<sup>23</sup> Article L. 533-12 of the Monetary and Financial Code, Articles 314-18 and 314-33 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 and Articles 28 to 34 of Directive 2006/73/EC of the Commission of 10 August 2006.

<sup>24</sup> Article 314-11 of the AMF General Regulation. See Article 27 of Directive 2006/73/CE of the Commission of 10 August 2006.

<sup>25</sup> Article 325-7 of the AMF General Regulation.

<sup>26</sup> Article L. 341-11 of the Monetary and Financial Code.

<sup>27</sup> Article L. 533-13 of the Monetary and Financial Code and Article 314-43 and the following articles of the AMF General Regulation as well as Article L. 541-4 of the Monetary and Financial Code. See Articles 19, 4 and 5 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 and Articles 35 and 36 of Directive 2006/73/EC of the Commission of 10 August 2006.

c) Finally, investment services providers, financial investment advisers and direct marketers of banking and financial services that are not covered by a) and b) of this paragraph, when they market the structured financial instruments mentioned in paragraph 3 and:

- the face value or initial subscription amount is EUR 50,000 or more (or the equivalent in another currency) and
- the product is being marketed for the purpose of diversifying a retail client's portfolio. The obligation to diversify the portfolio must be assessed according to the total savings invested in financial instruments. Accordingly, these instruments must not be marketed in such a way that the client's financial assets become over-concentrated in them.

However, in such cases, 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.

## 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.  AMF Instruction 2005-01 stipulates that marketing materials for structured funds and funds governed by Article L. 214-35 of the Monetary and Financial Code (funds subject to streamlined investment rules) shall be submitted to the AMF as part of the authorisation procedure. Furthermore, the application for authorisation to market European UCITS in France must include the proposed marketing materials.		
Language that must appear in advertisements and marketing materials	<p><b>In very visible print:</b></p> <p>« <i>Le prospectus d'émission du titre de créance complexe proposé a été visé par [nom du régulateur].</i> <b>Cependant, l'AMF considère que ce produit est trop complexe pour être commercialisé auprès des investisseurs non professionnels et n'a dès lors pas examiné les documents commerciaux.</b> Ces supports sont établis par [nom(s) de la (ou des) entités responsables].</p> <p>« <i>L'OPCVM proposé a été agréé par [nom du régulateur].</i> <b>Cependant, l'AMF considère que ce produit est trop complexe pour être commercialisé auprès des investisseurs non professionnels et n'a dès lors pas examiné les documents commerciaux.</b> Ces supports sont établis par [nom(s) de la (ou des) entités responsables]</p>	<p>If the advertisement mentions the fact it has been submitted to the AMF, the following language must be inserted:</p> <p>« <i>Le prospectus d'émission du titre de créance complexe proposé a été visé par [nom du régulateur]. Ce support est établi par [nom(s) de la (ou des) entités responsables]</i></p> <p>« <i>L'OPCVM proposé a été agréé par [nom du régulateur]. Ce support est établi par [nom(s) de la (ou des) entités responsables]</i><sup>28</sup></p> <p>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.</p>	No specific language is required under the terms of this position <sup>29</sup> .

<sup>28</sup> “The issuance prospectus for the complex debt security being offered has been approved by [regulator’s name]. This prospectus has been compiled by [name(s) of the responsible entity(ies)].

“The fund being offered has been authorised by [name of regulator]. This advertisement has been compiled by [name(s) of the responsible entity(ies)].

<sup>29</sup> 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 50,000 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.