UNDERSTANDING THE STRUCTURE

The implications of the Markets in Financial Instruments Directive - MiFID II - are slowly becoming more apparent to the UK financial services community as we rush towards the initial implementation of the legislation in 2016. The industry has not necessarily recognised the impact of some strands of the Directive, particularly around structured products and deposits which arguably are more difficult for retail investors to understand than mutual funds and other investments.

Guidelines setting out which investment products should be classified as complex under forthcoming European legislation have been criticised by the industry who feel the approach taken by standard-setters is "blunt" and "too broad" to be effective. This has been raised at recent TISA events to explain the implications.

The European Securities and Markets Authority (ESMA) is consulting on guidelines for the distribution of investment products under MiFID II. The Directive requires investment firms to conduct an appropriateness test on retail clients for products classified as ‘complex', to determine whether or not the product is a suitable purchase.

ESMA's proposed list of products that the test should be applied to has been met with particular concern, particularly that an asset-backed security is automatically complex, or that a special purpose vehicle-issued instrument is automatically complex. Real concerns have been raised that this will be very difficult to implement in business models and delivery to consumers. The guidelines address the aspect of the complexity of an investment and not particularly their risk. Among the products ESMA lists as complex for the purposes of the appropriateness test include warrants, inflation-linked bonds, asset-backed securities and investments captured by the packaged retail investments and insurance-based products regulation (Priips). The real devil in the detail here is that currently the industry does not have the definitive list as to what constitutes a complex product.

Deutsche Bank was one institution to publicly comment on the draft guidelines. In its official response to ESMA, they wrote: "The difficulty in finding the right balance stems from the fact that complexity is not an objectively measurable characteristic of a financial product and depends on the individual investor's knowledge and perception." The response goes on to challenge ESMA's suggestion that proprietary index-linked investments and products linked to a currency other than that of the retail investor's domicile should be automatically stamped as complex.

The inclusion of structured deposits in the complexity debate has also caused issues. The UK Financial Conduct Authority issued a discussion paper on its approach to implementing MiFID II in March. While acknowledging that advisers need to ensure investor suitability before distributing products, some in the industry argue that understanding structured deposits and investments does not require any greater investment knowledge or experience than understanding mutual funds, and therefore that regulatory requirements for these products should be no more onerous than for other types of investment. ESMA probably has a view that the prescriptive approach is one that provides certainty to the industry, and can bring a consistent approach across Europe and different financial institutions.

TISA is currently forming an industry working group to collaborate with both the UK and EU regulators to try and resolve the core understanding of component parts of MiFID and perhaps the establishment of some agreed open industry standards to help the implementation of this regulation.

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