

## **CNMV CIRCULAR 1/2018, OF 12 MARCH ON WARNINGS RELATING TO FINANCIAL INSTRUMENTS**

I

Information transparency is one of the fundamental pillars of the conduct of business rules governing the provision of investment services. In recent years, the financial instruments offered to retail clients have become increasingly sophisticated as, in response to a demand for higher returns, such clients are being given access to increasingly complex instruments. The cases of inappropriate marketing of financial instruments in Spain have revealed shortcomings in retail clients' understanding of the nature and risks of financial instruments when they make investment decisions.

It is therefore necessary to strengthen the informed consent of retail clients when they purchase investment products, especially when such products are particularly complex. It should be remembered that current legislation allows retail clients to purchase any type of product, however complex or risky it may be, even when the distributor believes that the product is not appropriate for such clients and has thus warned them.

The growing sophistication of financial instruments and retail clients' ever-increasing access to such products makes it advisable that, for particularly complex products, such clients should receive investment advice from a professional (who should assess the client's financial position, as well as their knowledge and experience, before recommending purchasing the product). However, current legislation allows entities to offer these products to retail clients on a non-advised basis.

Consequently, when entities decide to market these types of sophisticated products on a non-advised basis, without assessing suitability, and thus only analyse the investor's knowledge and experience, retail clients must be clearly warned of the high level of complexity of the instrument in question as they may find it difficult to assess and understand all the risks inherent to the product. Therefore, in order to ensure that retail clients give informed consent and enjoy effective protection, it is deemed appropriate that the warning in such cases should be accompanied by a handwritten statement together with the client's signature.

In addition, the instruments of this type that have been acquired previously and are held by clients on the date of entry into force of this Circular must be identified and be the subject of a one-time warning in the first statement of financial position sent to retail clients after the Circular enters into force.

## II

Law 11/2015, of 18 June, on the recovery and resolution of credit institutions and investment firms, regulates the bail-in tool. The ultimate aim of this tool, as indicated in the explanatory memorandum of the aforementioned Law, is to internalise the resolution cost within the financial institution itself.

In an institution resolution scenario (a process applicable when the institution is failing or likely to fail in the near future and for reasons of public interest and financial stability, it is deemed necessary to avoid its winding up under ordinary insolvency proceedings), the liabilities that are eligible for the bail-in tool may be converted into shares or undergo a reduction in their principal, and therefore their holders will incur the relevant losses. Unlike the mechanisms for hybrid instruments provided for in Law 9/2012, of 14 November, on the restructuring and resolution of

credit institutions, which limited loss absorbency to subordinated debt, in bail-in cases, loss absorbency is extended to all types of creditors.

Therefore, within the scope of the powers conferred on the CNMV, this Circular aims to strengthen the informed consent of retail clients when they purchase investment products which are also liabilities eligible for the bail-in tool, by establishing a specific warning in this regard which must be issued when retail clients are about to purchase such instruments.

In addition, the instruments of this type that have been previously acquired and are held by clients on the date of entry into force of this Circular must be identified and be the subject of a one-time warning in the first statement of financial position sent to retail clients after the Circular enters into force.

This approach is consistent with the 2 June statement issued by the European Securities and Markets Authority on MiFID practices for firms selling financial instruments subject to the BRRD resolution regime (ESMA/2016/902).

### III

Furthermore, it is difficult for retail clients to estimate the current value of certain instruments at the time of purchase or sale, especially in the case of instruments whose final return depends on the performance of one or several underlying assets.

In the case of complex issues aimed at retail clients, where there is a significant difference between the placement price and the market value that would be demanded by professional and qualified investors, the CNMV requires a warning to be included highlighting said fact in the information documents of the financial instrument. The CNMV believes it is

necessary to standardise this aspect not only in these cases, but also in the other cases covered by this Circular.

Therefore, in order for retail clients to be adequately informed about certain types of products that are not sufficiently transparent with regard to all the costs and charges they entail, clients should be warned when there is a significant difference in the distributor's estimate of the current value of the instrument and the price or sum at which the retail client will trade, including any explicit fees that may be applied.

#### IV

The third final provision of Law 9/2012, of 14 November, on the restructuring and resolution of credit institutions, introduced certain amendments to the Securities Market Act 24/1988, of 28 July. One of these changes affected Article 79 *bis*(3) - the current Article 210(3) of the recast text of the Securities Market Act - relating, *inter alia*, to the information on financial instruments that entities must provide to clients. This article authorises the CNMV to require that the information given to investors before purchasing a financial instrument should include as many warnings relating to the financial instrument as deemed necessary and, in particular, although not exclusively, warnings highlighting the fact that the financial instrument is not appropriate for non-professional investors due to its complexity.

The aim of this measure is to strengthen investor protection. It supplements other amendments introduced by the aforementioned Law 9/2012, of 14 November, such as those relating to warnings and information for clients set out in Article 79 *bis*(6) and (7) of the Securities Market Act 24/1988, of 28 July - the current Articles 213 and 214 of the recast text of the Securities Market Act - implemented by means of CNMV

Circular 3/2013, of 12 June, on implementation of certain information obligations relating to the financial instrument appropriateness and suitability test for clients of investment services.

The explanatory memorandum of the aforementioned Law 9/2012, of 14 November, stresses that its contents strengthen the CNMV's oversight powers relating to the marketing of investment products by entities, especially with regard to complex products.

This Circular is issued under the authority conferred on the CNMV to require that the information given to investors prior to purchasing a financial instrument should include certain warnings relating to the instrument. The aim of this Circular is to specify the warnings to be made regarding their high level of complexity, their eligibility for the bail-in tool and the existence of a significant difference with regard to the current value. To this end, the different types of financial instrument and the nature of the client have been taken into consideration.

#### V

The Circular contains four rules, one transitional provision and one final provision.

Rule One sets out the scope of application, which covers the provision of investment services other than discretionary portfolio management to retail clients in Spanish territory by the following companies: Spanish investment firms, credit institutions or collective investment scheme management companies, EU or non-EU branches of the above and their agents established in Spain, as well as investment firms, credit institutions and collective investment scheme management companies from non-EU Member States that provide said services without a branch.

Rule Two lists those financial instruments which, in the CNMV's opinion, are generally not appropriate for retail clients due to their high level of complexity. It establishes the content of the warning to be made both to retail clients that are under professional advice and those which operate on a non-advised basis. This is also applicable even if the entities perform an analysis of the personal characteristics of said retail clients and judge the instruments to be appropriate or suitable. It also specifies the manner in which said warnings must be made. When selecting the instruments to be included under this rule, the CNMV focused on the categories of particularly complex instruments that have on occasion been marketed to retail clients in recent years. There may, therefore, be other highly-complex instruments that have not been included in the Circular at this time because they are rarely or never marketed to retail clients. It is thus possible that the CNMV may decide to add other instruments to the list in the future.

Rule Three details the warnings to be made when retail clients are about to purchase a financial instrument which is also a liability eligible for the bail-in tool.

Rule Four identifies a series of financial instruments for which warnings must be given to retail clients in the documentation provided to them when they are going to purchase or sell the product. Such warnings should inform about the existence of a significant difference between the effective amount at which the transaction will be performed, including, where appropriate, any applicable explicit fees, and the estimate that the company makes of its current value. Specifically, the Circular establishes those cases in which a significant difference is deemed to exist and the manner in which this warning must be made.

The transitional rule establishes that it is necessary to identify particularly complex financial instruments that are generally not appropriate for retail clients and the financial instruments which are, in turn, liabilities that are eligible for the bail-in tool held by clients on entry into force of this Circular. A one-time warning about such instruments must be given in the first statement of financial position sent to retail clients after the Circular enters into force.

In its meeting held on 12 March 2018, the CNMV, in use of the powers granted to it, in accordance with the Council of State and following a report from the Advisory Committee and the Bank of Spain, provided:

**Rule one. Scope of application.**

This Circular will apply to the following entities when they provide investment services other than the discretionary and individualised portfolio management provided for in Article 140(d) of the recast text of the Securities Market Act, approved by Royal Legislative Decree 4/2015, of 23 October, to retail clients in Spain:

- a) The investment firms referred to in Article 143 of the recast text of the Securities Market Act, approved by Royal Legislative Decree 4/2015, of 23 October, including natural persons with the status of financial advisory firms.
  
- b) The credit institutions and collective investment scheme management companies referred to in Article 145 of the recast text of the Securities Market Act, approved by Royal Legislative Decree 4/2015, of 23 October, as entities authorised to provide certain investment services and ancillary services.

c) The following foreign entities:

1) The branches in Spain of the entities mentioned in a) and b) above that are authorised in a Member State of the European Union or in a third State.

2) The entities mentioned in letters a) and b) above that are authorised in a Member State of the European Union when they operate in Spain through an agent established in Spanish territory.

3) The entities mentioned in letters a) and b) above that are authorised in a non-Member State of the European Union when they operate in Spain without a branch.

**Rule two. Warnings relating to particularly complex financial instruments that are generally not appropriate for retail clients.**

1. The following financial instruments are subject to the provisions contained in sections 2 to 11 of this rule.

a) Financial instruments that, according to credit institution solvency legislation, are calculated as common Equity Tier 1, additional Tier 1 or Tier 2 and equivalent instruments from third countries. Shares which are deemed non-complex financial instruments in accordance with Article 217 of the recast text of the Securities Market Act, approved by Royal Legislative Decree 4/2015, of 23 October, are excluded.

b) Bonds, debentures and other similar negotiable debt securities and financial contracts not traded on official secondary markets through which a credit institution receives cash from its clients and assumes an obligation to repay, within a certain period in the form of the delivery of

securities, the payment of a sum of money or both when the issuer does not commit to repaying, on maturity, a percentage equal to or greater than 90% of the amount received, and providing that its result or the amount to be repaid is linked to the occurrence of events relating to the credit risk of one or more entities.

c) The bonds, debentures and other similar negotiable debt securities set out in Article 2(1)(c) of the recast text of the Securities Market Act, approved by Royal Legislative Decree 4/2015, of 23 October, when their issuer does not commit to repaying, on maturity, a percentage equal to or greater than 90% of the initial investment, where the return of the remaining percentage is dependent on the performance of one or several specific underlying assets, providing that they also involve complex structures that make it difficult for retail clients to understand the risks inherent to the instrument.

d) Financial contracts not traded on official secondary markets whereby a credit institution receives cash from its clients and assumes an obligation to repay, within a certain period in the form of the delivery of securities, the payment of a sum of money or both, dependent on the performance of one or several specific underlying assets, when the credit institution does not commit to repaying, on maturity, a percentage equal to or greater than 90% of the amount received, and providing that they also involve complex structures that make it difficult for retail clients to understand the risks inherent to the instrument.

e) Collective investment schemes with a specific target return, whether guaranteed or not, in a specific period of time, when at the end of said period, the target is not equal to or greater than 90% of the investment, with the achievement of said target is dependent on the performance of one or several specific underlying assets, and it is calculated using an

algorithm, providing the instrument also involves complex structures that make it difficult for retail clients to understand the risks inherent to the instrument.

f) Financial contracts for differences and binary options.

g) The other financial instruments set out in Article 2(2), (3), (5), (6) and (8) of the recast text of the Securities Market Act, approved by Royal Legislative Decree 4/2015, of 23 October, except where such instruments are derivatives traded on regulated markets, multilateral trading facilities or organised trading facilities and providing they include complex structures that make it difficult for retail clients to understand the risks inherent to the instrument. This excludes financial derivatives that the entity may offer to the client for the latter to hedge or reduce the financial risks they having occurred in other financial positions or specific and identified pre-existing commercial transactions, providing the financial institution marketing such instruments has previously verified that such derivatives substantially fulfil that purpose.

h) Any other instrument determined by the CNMV following a specific analysis and after said decision has been notified or published.

2. For the purposes of this rule, a financial instrument will be deemed to involve complex structures that make it difficult for retail clients to understand the risks inherent to that instrument when the underlying asset (or one of the underlying assets if there are more than one) is not traded daily on a market where a daily price that is reached through back-to-back buying and selling transactions among independent parties is made public, or whenever the underlying assets are collective investment schemes that do not publish their net asset value daily.

In addition, in the case of the instruments referred to in section 1(g), a complex structure that makes it difficult for retail clients to understand the risks inherent to the instrument is deemed to exist where, even though the underlying asset is traded daily on a market where a daily price that is reached through back-to-back buying and selling transactions among independent parties is made public, the instruments are highly speculative. Financial instruments will be deemed highly speculative for these purposes when clients may close or cancel their positions on a continuous basis throughout the life of the instrument at any time prior to maturity.

3. Entities that provide investment services within the scope of this Circular other than investment advice relating to any of the financial instruments set out in section 1 must provide a warning to retail clients with the following content:

“Warning:

You are about to purchase a product that is not simple and may be difficult to understand: (*The product should be identified here*). As a general rule, the CNMV considers that such products are not appropriate for retail clients, due to their complexity. However, ZZZ (*name of the institution*) has assessed your knowledge and experience and deems the product appropriate for you.”

In the case of instruments included in section 1 in which the retail client may assume financial commitments for an amount greater than the instrument’s purchase cost, a second paragraph must be added with the following content:

“This is a product with leverage. You should be aware that losses may be higher than the amount initially paid to purchase the product.”

This warning will be made irrespective of whether, as the case may be, the key investor information document that must be given to the client in accordance with Regulation (EU) No 1286/2014, of the European Parliament and of the Council, of 26 November, on key information documents for packaged retail and insurance-based investment products, contains the comprehension alert referred to in Article 8(3)(b) of the Regulation.

4. The entity must obtain the retail client's signature to the text referred to in the above section along with a handwritten statement saying:

"Product that is difficult to understand. The CNMV considers that, in general, it is not appropriate for retail investors ".

5. In the event that, in addition to the warning referred to in section 3, the entity needs to issue a warning stating that it deems the product or service to be inappropriate for retail clients, as stipulated in section 4 of Rule Four of CNMV Circular 3/2013, of 12 June 2013, on the implementation of certain information obligations relating to the financial instrument appropriateness and suitability test for clients of investment services, both warnings should be issued together.

In this case, the first paragraph of the warning described in section 3 should be amended by removing the last sentence. It will not be necessary to obtain the handwritten statement referred to in section 4. It will be sufficient to only have the handwritten statement referred to in section 4 of Rule Four of Circular 3/2013, of 12 June 2013.

6. In the event that, in addition to the warning referred to in section 3, the entity must also issue a warning stating that a lack of information has

prevented it from establishing whether the investment product or service is appropriate, as stipulated in section 2 of Rule Four of Circular 3/2013 of 12 June 2013, the two warnings should be issued together.

In this case, the first paragraph of the warning provided for in section 3 will be modified by removing the last sentence. It will only be necessary to obtain the handwritten statement referred to in section 4 and not the handwritten statement provided for in section 3 of Rule Four of Circular 3/2013, of 12 June 2013.

7. These warnings and handwritten statements will form part of the contractual documentation even when formalised in a separate document from the purchase order.

8. Entities that provide investment advice within the scope of application of this Circular relating to any of the financial instruments listed in section 1 will need to include the following warning in the description of how their recommendation suits the retail client's characteristics and goals referred to in section 1 of Rule Three of Circular 3/2013, of 12 June 2013:

“This investment proposal includes the following financial instruments: *YYY (the instruments should be identified here)*, which are not simple and may be difficult to understand. As a general rule, the CNMV considers that such products are not appropriate for retail clients, due to their complexity. However, *ZZZ (name of the entity)* has concluded that they are suitable for you”.

In the case of instruments included in section 1 in which the retail client may assume financial commitments for an amount greater than the instrument's purchase cost, a second paragraph must be added with the following content:

“This is a product with leverage. You should be aware that losses may be higher than the amount initially paid to purchase the product.”

9. In cases where services are provided by telephone, the entity shall keep a recording of the relevant retail client's oral statement in accordance with this rule. The client will be granted access to the recording, should they so request.

10. In the event that the services are provided online, the entity must establish the necessary means to ensure that the retail client can type the corresponding handwritten statement of those indicated above prior to processing the order. The entity must be able to demonstrate that the client has done so.

11. There will be no need for entities to issue warnings or obtain handwritten statements under this rule when the retail client has at least two outstanding positions in instruments whose nature and risks are broadly similar with regard to which the client has already received said warnings. Nor will it be necessary for entities to issue warnings to clients who have already received such warnings at least twice about instruments whose nature and risks are broadly similar, except in cases where the most recent warning was issued more than three years previously or where the entity needs to warn the client that it deems the product or service inappropriate for the client or that a lack of information prevents it from establishing whether or not the investment product or service is appropriate.

**Rule three. Warnings with regard to financial instruments that are also liabilities eligible for the bail-in tool.**

1. The financial instruments listed in Article 2 of the recast text of the Securities Market Act, approved by Royal Legislative Decree 4/2015, of 23 October, which are also liabilities eligible for the bail-in tool in accordance with Chapter VI of Law 11/2015, of 18 June, on the recovery and resolution of credit institutions and investment firms, or their equivalents in accordance with Directive 2014/59/EU, of the European Parliament and of the Council, of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms or any similar legislation of third countries, are subject to the provisions contained in sections 2 to 4 of this rule.

2. Entities that provide investment services within the scope of this Circular relating to any of the financial instruments set out in section 1 must provide a warning to retail clients with the following content:

“Warning:

You are about to purchase a product that is a liability eligible for the bail-in tool: (*The product should be identified here*). In the event of the resolution of the issuer of said financial instrument (a process applicable when the issuer is failing or likely to fail in the near future and for reasons of public interest and financial stability it is deemed necessary to avoid its winding up under ordinary insolvency proceedings), the product may be converted into shares or undergo a reduction in its principal, and its holders will incur the corresponding losses.”

3. The entity must obtain the retail client's signature to the text mentioned in the previous section. This warning shall form part of the contractual documentation, even when it is formalised in a separate document from the purchase order. In the event that the service that is provided is

investment advice, this warning will need to be included in the description referred to in section 1 of Rule Three of Circular 3/2013, of 12 June 2013, on how the recommendation given matches the investor's characteristics and goals.

4. In the event that in addition to the warning referred to in section 2, the entity also needs to issue the warning that it considers the product or service inappropriate for the retail client or that a lack of information prevents it from establishing whether or not the investment product or service is appropriate, or the warning set out in Rule Two herein, these warnings should be issued together.

**Rule four. Warnings relating to the existence of the significant difference with regard to the estimate of the current value of certain financial instruments.**

1. The following financial instruments are subject to the provisions contained in sections 2 to 4 of this rule.

The marketable securities included in Article 2(1)(b), (c), (d), (e), (g), (h), (i) and (k) of the recast text of the Securities Market Act, approved by Royal Legislative Decree 4/2015, of 23 October 2015, if the entity that provides the investment service acts as counterparty to the retail client, including cases where it acts on its own account between two clients.

b) Financial contracts not traded on official secondary markets whereby a credit institution receives cash from its clients and assumes an obligation to repay within a certain period in the form of the delivery of securities, the payment of a sum of money or both, dependent on the performance of one or several specific underlying assets, when the credit institution does not commit to repaying, on maturity, the entire sum it received.

c) The other financial instruments set out in Article 2(2) to (3) and (5) to (8) of the recast text of the Securities Market Act, approved by Royal Legislative Decree 4/2015, of 23 October, except where such instruments are derivatives traded on regulated markets, multilateral trading facilities or organised trading facilities, or except where their issuers or distributors grant retail clients daily opportunities to buy and sell and also provide their retail clients with information about the prices at which such operations are carried out.

2. Whenever an entity intends to provide investment services within the scope of application of this Circular relating to any of the financial instruments listed in section 1 and the absolute difference between the actual price which the retail client pays in the transaction, including any explicit fees that may be applied, and the entity's estimate of the current value of the instrument exceeds 5% of the latter or where it does not exceed 5%, but is greater than 0.6% multiplied by the number of years to maturity when there is a maturity date, a warning should be issued. For the purposes of this warning, the total cost will be considered the absolute difference between the actual price including explicit fees and the estimate made of the instrument's current value. In the case of the derivative instruments included in section 1(c), the aforementioned difference or total cost will be calculated in relation to the instrument's notional amount.

The warning shall have the following content:

“Warning:

In line with the estimated current value of the YYYY financial instrument (*the financial instrument should be identified*) that was calculated by ZZZ (*the name of the entity that performed the estimate*), and considering all transaction costs, you are paying an

approximate total cost of X% (*a percentage needs to be specified*) of the estimated current value of this instrument / the notional amount of this instrument (*the option corresponding to the type of instrument in question will be included*)."

For these purposes, the current value is the sum for which the financial instrument could be exchanged between well-informed, knowledgeable, willing parties in an arm's length transaction in the principal (or most advantageous) market. The entity's estimate at each time of said current value must be reached following generally accepted methodologies and be consistent with the estimates the entity would use to assess a similar instrument purchased or sold on its own account and, at any event, consistent with the calculation criteria established in the implementing legislation of Regulation (EU) No 1286/2014, of the European Parliament and of the Council, of 26 November 2014, on key information documents for packaged retail and insurance-based investment products.

3. The entity must obtain the retail client's signature to the text referred to in the previous section. This warning will form part of the contractual documentation even when formalised in a separate document from the client's order.

4. To establish the number of years to maturity for the purposes of the provisions of this rule, the following factors will be taken into account:

a) In the case of instruments whose purchase involves no initial outlay, the number of years to maturity will be the years left until the instrument's final maturity.

b) In the case of instruments whose purchase involves an initial outlay that is to be repaid or may be repaid on a single maturity date, the

number of years to maturity will be the years left until that single maturity date.

c) In the case of instruments whose purchase involves an initial outlay that may or may not be repaid, at various percentages, on various dates, the number of years to maturity will be established by weighting the various theoretical maximum sums that are to be repaid, with the maximum limit of the initial outlay, by the number of days left until repayment. The number of years that remain in the instrument's lifespan will be expressed to two decimal places.

When one single sum can be repaid on various dates depending on whether or not certain conditions are met, repayment will only be considered to take place on the mean date of all maturity dates in question.

When, given the nature of the instrument, it is not possible to establish the theoretical maximum sums that need to be repaid on any given date, the number of years to maturity will be the years left until the instrument's final maturity.

d) In the case of instruments that are perpetual or have no maturity date, the number of years to maturity will not be established.

**Single transitional provision. Warnings in statements of financial position with regard to particularly complex financial instruments that are not generally appropriate for retail clients or with regard to financial instruments that are also liabilities eligible for the bail-in tool.**

The entities referred to in Rule One of this Circular which, on its entry into force, hold financial instruments of retail clients included in those listed in Rules Two and Three must identify them clearly, as the case may be, as instruments that the CNMV considers to be inappropriate for purchase by retail clients due to their complexity or as liabilities eligible for the bail-in tool in the first periodic statement of financial position that must be sent to said retail clients subsequent to the date the Circular enters into force, in accordance with the provisions of Article 70 of Royal Decree 217/2008, of 15 February 2008, on the legal framework of investment firms and other entities that provide investment services and partially amending the Regulation of Law 35/2003, of 4 November, on Collective Investment Schemes, approved by Royal Decree 1309/2005, of 4 November.

In addition, the following warnings, where appropriate, shall be included in said statements:

“Warning:

This statement identifies certain financial instruments that are liabilities eligible for the bail-in tool. In the event of the resolution of the issuer of said financial instruments (a process applicable when the issuer is failing or likely to fail in the near future and for reasons of public interest and financial stability, it is deemed necessary to avoid its winding up under ordinary insolvency proceedings), the products may be converted into shares or undergo a reduction in their principal, and their holders will incur the corresponding losses.”

“Warning:

As from XX/XX/XX (*date of entry into force of this Circular*), it is mandatory to warn, before purchasing, that the CNMV considers that certain financial instruments are not simple and may be

difficult to understand and therefore, due to their complexity, they are not generally considered appropriate for purchase by retail clients. This statement identifies instruments included under said obligation.”

In periodic statements of the financial position, it will only be mandatory to identify said financial instruments on one single occasion and the warnings included in this transitional provision will only affect positions held by retail clients about which information must be provided in the first statement of financial position that is sent to clients after this Circular enters into force.

The warning relating to financial instruments that are also liabilities eligible for the bail-in tool referred to in this transitional rule does not need to be issued when the retail client has already been given this information in accordance with the 2 June statement issued by the European Securities and Markets Authority on MiFID practices for firms selling financial instruments subject to the BRRD resolution regime (ESMA/2016/902).

**Single final provision. Entry into force.**

This Circular shall enter into force three months following its publication in the *BOE* (Official State Gazette).

Madrid, 12 March 2018.- The Chair of CNMV, Sebastián Albella Amigo.

