European Securities and Markets Authority

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Statement

MiFID practices for firms selling financial instruments subject to the BRRD resolution regime

1. The European Securities and Markets Authority (ESMA) is issuing this Statement to clarify how credit institutions and investment firms (referred to as "firms") should apply the relevant MiFID requirements governing the distribution to clients of financial instruments subject to the BRRD resolution regime, both on an advised and non-advised basis, as well as in the context of portfolio management.

Background

2. The Banking Recovery & Resolution Directive (BRRD, Directive 2014/59/EU) entered into force on 2 July 2014. EU Member States were required to transpose the Directive at national level by 31 December 2014 and to apply its provisions with effect from 1 January 2015, except in relation to the bail-in provisions, which were to apply from 1 January 2016 at the latest. During the recent financial crisis, a number of banks were bailed out with public funds. While this may have been necessary to prevent widespread disruption to the financial markets and real economy, it was considered that taxpayers' money should not be used in this way at the expense of other public objectives. The BRRD introduces a clear and comprehensive bank recovery and resolution regime – that covers both national and cross-border bank failures – which is crucial for ensuring long term financial and economic stability, and for minimising the potential public cost of possible future financial crises.

3. The BRRD, amongst other things, provides resolution authorities with a set of resolution tools and powers. These include the power to sell or merge the business with another bank, to set up a temporary bridge bank to operate critical functions, to separate good assets from bad ones and to convert to shares or write down the debt of failing banks (bail–in). In addition, bank capital instruments must be written down or converted when the relevant authority determines that the bank is no longer viable, which may occur before the point of resolution.

4. Bail-in, and other resolution tools and powers, can only be used when firms are judged to be failing or likely to fail and there is no reasonable prospect of their failure or likely failure being addressed within a reasonable timeframe; and where the use of resolution tools is necessary in the public interest. If the public interest test is not met, the firm would instead enter insolvency. The BRRD is part of a package of reforms designed to remove implicit

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government support and protection for creditors and investors in banks capital and debt instruments and other unsecured bank financial instruments, including retail investors. It introduces strict limits on the contribution of public resolution financing arrangements to absorb losses and recapitalise failed firms, requiring a contribution of at least 8% of the total liabilities - including own funds of the institution under resolution at the time of the resolution action - to absorb losses before any such sources of recapitalisation may be used.

5. Resolution is therefore an alternative to government bail-outs for failed firms. This new approach therefore may have implications for investors since resolution may potentially affect any financial instruments of the institution which are not secured by sufficient assets or collateral or subject to specific protections under the BRRD. Consequently investors could face full write down or partial loss of their investments in resolution as they will not be able to rely on expectations of 'bailouts' in the event of bank failure. This risk arising from the resolution potentially affects individual investors either directly or via their investment in funds and their pensions.

6. It is important to note that financial instruments subject to the resolution regime are usually offered by the issuing credit institutions and investment firms directly to their own clients or through other group entities to their clients (self-placement). Moreover, it is likely that to ensure compliance with the BBRD, a significant amount of financial instruments subject to the resolution regime will be issued by financial institutions. Under these circumstances, the obligation for intermediaries to act in the best interest of their clients should not be compromised as a result of prudential pressures.

7. In light of the above, some of the most relevant risks entailed in financial instruments subject to the resolution regime and in their distribution to clients may be identified as follows:

- Credit/Counterparty risk - As a result of the wide discretion[1] conferred on resolution authorities to intervene when a bank has met the conditions for resolution, and the potential lack of clarity on the timing of an intervention by the resolution authority, for understandable reasons, around their decision, it could be difficult for investors to understand the resolution regime and the wider 'conditions' under which losses can be incurred by investors themselves. Specifically, investors will generally have limited understanding of how the risk of losses under this set of circumstances differs from losses resulting from ordinary (non-financial) counterparty default and entry into insolvency. Moreover, as a consequence of prudential difficulties, the key terms of the investment could be amended by the resolution authority (for instance the maturity of the instrument can be modified or the payment of interest rate may be suspended for a pe-

[1] Resolution authorities have discretion in the choice of resolution tool, but must respect some safeguards for investors and other stakeholders. Collateral, set-off, and netting rights are protected. And all creditors and shareholders have a right to compensation if the treatment they receive in a resolution is less favourable than the treatment they would have received had the firm entered a normal insolvency process, based on an independent valuation.

riod of time). Legislation however mitigates these complexities by introducing the "No Creditor Worse Off" safeguard that provides that resolution cannot leave investors worse off than they would have been in normal insolvency proceedings.

- Liquidity risk - Due to the withdrawal of the implicit government guarantee for bank term debt and the introduction of resolution regimes, the liquidity of financial instruments subject to the resolution regime could become vulnerable to conditions/situations of stress in the financial markets[2]. Furthermore, when these instruments do not have a liquid secondary market it will be even more difficult for investors to perceive and react to the various signals concerning the economic/prudential conditions of the bank that issued the financial instruments subject to the resolution regime.

- Concentration risk – As mentioned, since banks and investment firms may directly sell the financial instruments subject to the resolution regime they issue to their clients, self-placement may amplify the risk of non-diversification in the investors' portfolio of this type of products.

Relevant MiFID requirements

8. ESMA notes that aside from the general duties of conduct (obligation to act in the best interest of the client and provide fair, clear and not misleading information), the existing MiFID and MiFID Implementing Directive contain several provisions which apply to firms when selling or advising on the sale of financial instruments, including those subject to the resolution regime, or providing portfolio management (in relation to the same financial instruments)[3]:

    - Information to clients: Article 19 of MiFID I and Articles 27, 29, 30, 31, 33 of the MiFID Implementing Directive (2006/73/EC).

    - Provision of investment advice: Articles 4(4) of MiFID I and Article 52 of the Implementing Directive.

[2] The sensitivity of the liquidity of liabilities subject to the resolution regime could be in addition exacerbated when a resolution authority steps-in since at this point the secondary market may dry-up altogether.

[3] The following provisions can also be relevant in relation to information on the risk of liabilities subject to the resolution regime:
- The Prospectus Regulation (Regulation (EC) No 809/2004 as amended by Commission Delegated Regulation (EU) No 486/2012) requires prominent disclosure of risk factors that are material to debt securities being offered and/or admitted to trading in order to assess the market risk associated with these securities (Item 2 on Risk factors, Annex V) and requires a description of the rights attached to the securities, including any limitation of those rights (Item 4.6 of Annex V). On December 2015 ESMA has published a new Q&A on Prospectuses referred to the level of disclosure that should be included in a prospectus when the securities which are the subject matter of the prospectus may be subject to write-down or conversion powers in accordance with the BRRD.
- Article 55(1) of BRRD, which provides (among other features) disclosure on contracts governed by the law of third country. On 3 July 2015, EBA delivered draft RTS to the European Commission specifying a list of mandatory components which should be present in the contractual term referred to in Article 55(1) of the BRRD. These include provisions specifying the express acknowledgement, agreement and consent of the counterparty to the application of write-down and conversion powers by the Resolution Authority and their potential effects in terms of the liability under the agreement (and pertinent draft RTS to the European Commission delivered by the EBA on July 2015).

- Suitability and appropriateness: Articles 19(4) and (5) of MiFID I and 35, 36, 37 and 38 of the Implementing Directive.
- Conflicts of interest: Article 13(3) and 18 of MiFID I and articles 21-23 of the MiFID Implementing Directive.

9. Firms should have in place solid procedures for the categorisation of their clients and should comply with the relevant MiFID requirements, set out above.

10. For the purposes of this statement, financial instruments subject to the resolution regime are all those unsecured financial instruments of an institution or entity referred to in points (a), (b), (c) or (d) of Article 1(1) of the BRRD and that fall within MiFID scope. It is however appropriate that firms take steps necessary to verify whether alternative products or products offering a significant exposure to such financial instruments raise similar questions and firms should be mindful not to amend the legal form of their investment propositions to clients in order to circumvent the MiFID requirements.

11. It should be noted that this statement is without prejudice to other work carried out in relation to specific types of instruments that have their own peculiar features, even if they are subject to the resolution regime, as well as in relation to any future work that may be conducted in the context of MiFID II (see page 10 – "Other relevant ESMA work", including the joint work done with EBA and EIOPA). In particular, it seems worth recalling that ESMA, in its Statement of July 2014[4], has already expressed the view that the ability to understand the characteristics and potential risks inherent to CoCos requires '*analysis* [that] *can only take place within the skill and resource set of knowledgeable institutional investors*'. However, the universe of instruments which meet the definition of a 'CoCo' is much narrower than the generality of bank financial instruments subject to the resolution regime.

<u>Disclosure</u>

12. The BRRD introduces strict restrictions on bailouts of bank investors. As such, it is important that clients understand the risks inherent in their investments in bank capital instruments and other financial instruments, in particular their rank in the insolvency creditor hierarchy relative to other investors. As a consequence of the complexity and novelty of the relevant regulation concerning the resolution regime and the discretion afforded to authorities within that regime it could also be difficult for clients to understand the outcomes that the resolution regime would deliver. On the contrary, the analysis of some investors' complaints has showed that, in some cases, investors are proactively approached by credit institutions and are wrongly given the impression that the recommended product is as safe as a deposit or is protected by a deposit guarantee scheme, neither of which facts is true. The BRRD requires national insolvency regimes to provide preferred creditor status

[4] See: ESMA statement on 'Potential risks associated with investing in Contingent Convertible Instruments' (Ref: ESMA/2014/944 – July 2014);

for depositors who are eligible for deposit guarantee scheme coverage[5] and for deposits of small and medium enterprises; other unsecured liabilities do not benefit from this status. Investors should receive fair, clear and not misleading information about the features and related risks of financial instruments subject to the resolution regime, so that they are reasonably able to understand them and that the BRRD has introduced strict limits on the use of public funds to protect bank debt investors from losses.

13. In particular, ESMA considers that firms should use simple and comprehensible language, avoiding any jargon, also providing a clear and straightforward explanation of any technical terms used. Information should be presented in an objective way, ensuring that the potential risks inherent in financial instruments subject to the resolution regime are not underestimated.

14. For the purpose of enabling investors to take informed decisions when investing in financial instruments subject to the resolution regime, firms should inform clearly clients about the wider conditions under which losses can be "imposed" as a result of the action of a resolution authority following the deterioration of the prudential situation of the firm.

15. ESMA is of the opinion that clients or potential clients investing in financial instruments subject to the resolution regime should receive accurate disclosure[6], at the point of sale, in good time and in any case before clients are bound by any agreement, at least on the fact that:

- the instruments are unsecured and therefore subject to the resolution regime;
- the impact on investors, in a resolution scenario, depends crucially on the rank of the liability in the resolution creditor hierarchy, which may have changed due to the introduction of depositor preference;
- in the event of resolution:
    - the outstanding amount may be reduced to zero or the security may be converted into ordinary shares or other instruments of ownership for the purpose of stabilisation and loss absorption;
    - a transfer of assets to a bridge bank or in a sale of business may limit the capacity of the firm to meet repayment obligations;

[5] It is important to note that the deposit guarantee scheme covers eligible deposits only up to a limit of €100,000 per person or per institution.

[6] While investment firms should inform retail clients about the existence of a prospectus this requirement is limited to cases where the financial instrument is the subject of a *current offer to the public* and does not discharge the investment firm from its duty to provide appropriate information to clients.

- the maturity of instruments or the interest rate under these instruments can be altered and the payments may be suspended for a certain period;

- the liquidity of the secondary market in any unsecured debt instruments may be sensitive to changes in financial markets;

- existing liquidity arrangements (for example, re-purchase agreements by the issuing institution) might not protect clients from having to sell these instruments at substantial discount below their principal amount, in case of financial distress of the issuing firm;

- liability holders have a right to compensation if the treatment they receive in resolution is less favourable than the treatment they would have received under normal insolvency proceedings. This assessment must be based on an independent valuation of the firm. Compensation payments, if any, may be considerably later than contractual payment dates (in the same way that there may be a delay in recovering value in the event of an insolvency).

16. In accordance with Article 29(6) of the MiFID Implementing Directive clients should also be properly informed, in good time, about any material changes to the information provided on investments in financial instruments subject to the resolution regime, including if any material changes occurred to the situation of the issuer or to the features/conditions of the instruments.

17. ESMA is also of the opinion that existing firms' clients who already hold financial instruments subject to the resolution regime (also through portfolio management services provided by a firm) should be provided with complete and updated information on the effects of BRRD on such investments (see paragraph 15).

18. ESMA considers that information to existing clients already holding financial instruments subject to the resolution regime as well as future notifications to new clients about material changes to information provided at point of sale should typically be provided by credit institutions and investment firms who maintain a relationship with their clients in which MiFID investment services are provided. This includes firms retaining a trading or brokerage account with their clients or providing advice on an on-going basis or firms who hold clients' financial instruments after they or entities having close links with them have carried out orders from these clients. Considering that financial instruments subject to the resolution regime often are offered by the same firms issuing them, or by entities having close links or any other legal or economic relationships with the issuer, it is normally expected that the relevant disclosure to these clients will be provided by the entity that has distributed the product to the client.

19. Firms should identify the appropriate way to convey the information relevant to investments in financial instruments subject to the resolution regime and the actual content of the communication provided. In particular:

(i) in case of new clients, information at the point of sale should be provided before the transaction is made;

(ii) investors already holding financial instruments subject to the resolution regime (also through portfolio management services provided by a firm) could receive the above information through periodic reporting or through a specific *ad hoc* communication. Firms could also provide this information through their website or other electronic media provided that these means of communication fulfil the conditions set out in Article 3 of the MiFID Implementing Directive;[7]

(iii) with regards to the additional information on future material changes, depending on their timing, the relevant disclosure could be provided through the ordinary reports to clients (if the release date of such reports is reasonably close to the event occurred) or via *ad hoc* communications including through their websites (as mentioned in point ii).

20. It should be pointed out that the content and details of disclosure to clients may vary depending on the specific nature and features of the instruments, so as to enable them to fully understand all the related risks they face. In particular, for more complex/riskier products, it is expected that firms should provide more thorough information.

21. Firms should provide appropriate information about the position of the investor in the resolution creditor hierarchy. For example, when investing in subordinated bonds, investors should be made aware of the potential consequences of a resolution measure or write-down and conversion of capital instruments being undertaken, i.e. that they will find themselves in a less favourable position compared to those holding a senior debt instrument. Investors in unsecured debt instruments should be made aware that they will find themselves in a less favourable position compared to holders of deposits when these are eligible for coverage by the deposit guarantee scheme. The extent of losses borne by a particular investor also depends crucially on the quantum of capital or financial instruments ranking junior or equal to their claim.

22. Investors entering into new agreements for the provision of portfolio management services should be informed *ex-ante* about the possibility of investments being made also into financial instruments subject to the resolution regime, with an explanation of the impact of BRRD on such investments, so as to enable the investor to make an informed decision about the nature of the service being offered. This type of disclosure could be provided, for example, within the pre-contractual information.

23. ESMA is of the opinion that contents of the above disclosure to clients should be drafted by the competent firm's functions under the close supervision of the compliance function that should also consider the appropriate way to deliver the information.

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[7] Directive 2006/73/EC

Provision of investment advice

24. As noted in the Joint ESA reminder to credit institutions and insurance undertakings on self-placement[8], investors appear to have been approached through aggressive selling techniques inducing them to invest in the financial instruments issued by the same credit institutions or by entities having close links or any other legal or economic relationships with the firm.

25. ESMA is of the opinion that, under self-placement situations, it is extremely likely that in substance the interaction between the investor and the credit institution involve personal recommendations (i.e. investment advice) being provided to clients. Firms are reminded that a thorough assessment of the suitability of the financial instrument for the client should be conducted.

Suitability and Appropriateness

26. To properly protect clients investing in financial instruments subject to the resolution regime, ESMA is of the opinion that firms should assess the possible impact of changes arising from the removal of implicit support for bank creditors and the BRRD on their existing internal procedures for the assessment of suitability and appropriateness in order to take into account the specificities (i.e. new level of risks) attached to each type of financial instrument affected by the new legislative framework.

27. ESMA is of the opinion that firms advising a client on financial instruments subject to the resolution regime or providing portfolio management should:

- consider the need to collect more in-depth information about the client than they would otherwise collect for similar instruments which are not subject to the resolution regime;

- ensure that firms' suitability assessment procedures adequately take into consideration the risk for the client to lose money because of the resolution mechanisms (i.e. credit risk measures should be adjusted to reflect the fact that clients could lose money even without entry into insolvency);

- take into account whether the risk associated with financial instruments used for resolution purposes is consistent with the financial and risk profiles of the client and that the client will be able to bear the relevant losses in the event that the firm should fail;

- avoid an excessive concentration of investments in financial instruments subject to the resolution regime issued by the firm itself or by entities of the same group. Therefore, firms should adopt all necessary measures and procedures to ensure that the concentration risk is effectively and substantially identified and mitigated, taking also into ac-

[8] Ref: JC 2014 62 (31 July 2014)

count the specific features of the securities offered as well as clients' financial situation, including their ability to bear losses, and their investment objectives, including their risk profile;

- take proper account of the complexity of these instruments both in relation to the difficulty for investors to understand the risks attached to these instruments and in relation to the need to employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them. To this effect, firms should devote special attention to the training of sales staff responsible for relationships with clients.

28. Furthermore, ESMA's view is that firms providing portfolio management should ensure that those clients' portfolios that include investments in financial instruments subject to the resolution regime remain consistent with the mandate received by their clients.

29. In the residual cases where clients invest in financial instruments subject to the resolution regime without the services of investment advice or portfolio management being provided, firms will still have to comply with the requirements on the appropriateness assessment set out in Article 19(5) of MiFID.

30. It should be noted that the firms' procedures for the suitability/appropriateness assessment should carefully consider the nature and characteristics of the instruments, including their complexity, possible returns, risks and liquidity.

<u>Conflicts of interest</u>

31. Firms are required to identify any conflicts of interest potentially arising with their clients (or between clients) and to maintain and operate effective organisational and administrative arrangements to prevent such conflicts from adversely affecting the interests of its clients.

32. In the case of distribution of financial instruments subject to the resolution regime issued by a firm or by other group entities, there is a heightened risk that the interests of a firm may come into conflict with the best interests of its clients. It is therefore important for firms to ensure that any targeting of financial instruments subject to the resolution regime to their clients does not compromise the overarching obligation to act honestly, fairly and professionally in accordance with the best interests of these clients, but duly takes into account their interests.

33. Firms should also have in place internal arrangements that ensure that the pricing of the financial instruments subject to the resolution regime does not promote the investment firms' interests, in ways that conflict with the client's interests. These arrangements (such as the validation of the pricing via a book building or an independent expert) become more important for those banks that are using self-placement as a channel to distribute their own instruments and for illiquid or non-standardised products where the pricing is difficult to assess due to the absence of commonly used benchmarks or of similar liquid products.

34. In addition, firms must also establish, implement and maintain a conflicts of interest policy. The policy should clearly specify the procedures to follow and measures to be adopted to manage such conflicts. In this context, ESMA is of the opinion that conflicts of interest policies that firms are required to establish should also include details on how staff engaged in the sale of these financial instruments subject to the resolution regime should act towards clients.

35. If arrangements by firms to manage conflicts of interest are not sufficient to prevent adverse impact on ensure the interests of a client, the firm must clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business for the client. The disclosure must be made in a durable medium and include sufficient detail, taking into account the nature of the client, to enable that client to take an informed decision with respect to the service in the context of which the conflict of interest arises. An overreliance on disclosure without adequate consideration as to how conflicts may appropriately be managed is not permitted.

36. Similarly, firms should also pay particular attention to the definition of general business policies and distribution strategies in order to avoid their own interests being favoured at the expense of the best interest of clients. Specifically, when designing their remuneration policies, firms should ensure that staff is not incentivised to distribute financial instruments subject to the resolution regime issued by the firm itself or by other entities of the group.

Other relevant ESMA work:

- ESMA opinion on MiFID practices for firms selling complex products (ESMA/2014/146);
- ESMA opinion on ‘Structured Retail Products - Good practices for product governance arrangements’ (ESMA/2014/332);
- Joint Committee reminder on the Placement of financial instruments with depositors, retail investors and policy holders ('Self placement') (JC 2014 62);
- ESMA statement on ‘Potential risks associated with investing in Contingent Convertible Instruments’ (ESMA/2014/944 – July 2014);
- ESMA Guidelines on certain aspects of the MiFID suitability requirements (ESMA/2012/387);
- CESR Q&As on ‘Understanding the definition of advice under MiFID’ (CESR/10-293).