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National Securities and Exchange
Commission Circular 1/2018 of 12 March
on financial instrument warnings

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On 15 March 2018, the National Securities and Exchange Commission (the “CNMV”) published Circular 1/2018 of 12 March on financial instrument warnings (“Circular 1/2018”) on its website. Circular 1/2018 has yet to be published in Spain’s Official State Gazette (“BOE”).

Circular 1/2018 will apply to those entities that provide **investment services but not discretionary investment management services for retail clients** in Spain; namely, investment firms, credit institutions and collective investment scheme management companies, these same European entities operating in Spain through a branch or an agent and these foreign non-EU entities that operate through a branch or on a freedom-to-provide-services basis (each of them, the “Entity” and together, the “Entities”).

The purpose of Circular 1/2018 is to increase retail investor protection when contracting certain sophisticated financial instruments and at the same time to increase transparency in their distribution.

Circular 1/2018 will enter into force three months after it is published in the BOE.

Below is a summary of Circular 1/2018.

WARNINGS REGARDING ESPECIALLY COMPLEX FINANCIAL INSTRUMENTS THAT IN GENERAL ARE NOT APPROPRIATE FOR RETAIL CLIENTS

According to Circular 1/2018, certain financial instruments are highly complex and have high levels of risk. This can make them not suitable for retail investors.

The following should be highlighted: (i) those which, according to credit institution solvency regulations, are determined as own resources; (ii) complex structured products (bonds, obligations, financial agreements or CIS institutions with a specific return, guaranteed or otherwise), in which the reimbursable amount is less than 90% of the initial investment and that also are not traded in markets in which prices are disclosed daily, or are linked to the occurrence of events relating to credit risks; (iii) OTC derivatives, with no hedging purpose, in which retail investors do not usually invest or which due

to their nature are highly speculative; or (iv) other highly complex instruments, such as binary options or CFDs.

Circular 1/2018 considers a complex structure, which makes it difficult for clients to understand the product, to exist when the underlying asset or some of the underlying assets, when there are two or more, are not negotiated on a daily basis in a market where a daily price is published (such daily price is published and obtained from cross-purchases between independent parties), or if the underlying assets are collective investment schemes, when their net asset value is not published on a daily basis.

To ensure that retail clients give informed consent before contracting an instrument and that therefore they are protected, Circular 1/2018 regulates the warnings that the information the Entities give to retail investors prior to contracting must contain. These warnings will vary depending on the services that the Entities render to each retail client.

Applicable warnings when no financial advisory service exists

Those entities that provide investment services that are not financial advisory services within the scope of Circular 1/2018, must give the following warning:

“Warning

You are about to purchase a product that is not simple and may be difficult to understand: (the product should be identified). The National Securities and Exchange Commission (CNMV) considers that due to the complexity of the product its acquisition is not suitable for retail clients in general. Nevertheless, ZZZ (name of the entity) has assessed your knowledge and experience and considers that the product is suitable for you” .

The following must also be included when the retail client can assume financial undertakings that exceed the acquisition cost of the instrument:

“This is a leveraged product. You should be aware that the losses may exceed the amount of the initial investment for its acquisition”.

This warning will be made independently from the key investor information document (KIID) that should be given to the client pursuant to 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 (PRIIPs).

Finally, the Entity must collect the signature of the retail client and in turn the retail client must make the following statement:

“This product is difficult to understand. The CNMV considers that it is not suitable for retail investors in general”.

In other cases, the warnings will need to be adjusted to the circumstances of the retail client (i.e. when the Entity concludes that the instrument is not suitable for the retail client or when the Entity does not have sufficient information to determine whether or not the instrument is appropriate).

Circular 1/2018 also regulates how the abovementioned warnings should apply in the event that the warnings in National Securities and Exchange Commission Circular 3/2013 of 12 June on specific information obligations for clients to whom investment services are provided, also apply in relation to determining the suitability of the financial instruments.

Applicable warnings when financial advisory service exists

In cases where the Entity renders financial investment advice, it must include the following warning in the description of how the recommendation made is compatible with the characteristics and objectives of the retail client:

“This investment proposal includes the following financial instruments: YYY (the instruments should be identified), which are not simple and could be difficult to understand. The National Securities and Exchange Commission (CNMV) considers that due to the complexity of the product its acquisition is not suitable for retail clients in general. Nevertheless ZZZ (name of the entity) considers that the product is suitable for you”.

This same warning must be included if there is no financial advisory service but the retail client can assume financial undertakings that exceed the acquisition cost of the instrument.

General provisions

In cases where the service is provided online (by telephone or electronically), the Entity must ensure that the retail client has been warned in the same way as if the service were provided face-to-face. The Entity must prove that the retail client has been given the relevant warnings.

In certain scenarios, it will not be necessary to give the abovementioned warnings. For example, when the retail client has at least two open positions in instruments which nature and risks are substantially

similar to others on which the client has already been warned. Another example is when the client has carried out transactions with instruments that have a similar nature and risk, on at least two occasions, unless the latest warning has been made three years before the contracting of the instrument or the Entity warns that the instrument is not suitable for the retail client or the lack of information impedes it from determining whether the product is suitable.

FINANCIAL INSTRUMENT WARNINGS WHICH AT THE SAME TIME ARE EQUITY INSTRUMENTS OR BAIL-IN ELIGIBLE LIABILITIES

The regulation on the recovery and resolution of credit institutions and investment firms contemplates the possibility of applying certain instruments to their bail-in before they become insolvent. In those cases, the CNMV considers that retail clients may face significant losses in their investments.

In those cases, Circular 1/2018 establishes that Entities that provide investment services relating to any of the financial instruments that can be used for the bail-in of an Entity must give the following warning, as well as collect the signature of the retail client:

“Warning

You are about to purchase a product which is an equity instrument or a bail-in eligible liability: (the product should be identified). In the event of the resolution of the issuer of such financial instrument (applicable process when the issuer is insolvent or it is expected that it will become insolvent in the near future and due to public interest and financial stability it is necessary to avoid its insolvency), such product could be converted into shares or its principal reduced and, as a result, its holders could make losses in their investment”.

When the Entity considers that the instrument is not appropriate for the client, or the absence of information impedes it from determining whether it is, such warnings must be given along with the abovementioned one.

Finally, in those cases where the services are investment advice, the abovementioned warning must be included in the description of how the recommendation made is compatible with the characteristics and objectives of the investor.

WARNINGS ON THERE BEING A SIGNIFICANT DIFFERENCE REGARDING THE ESTIMATE OF THE CURRENT VALUE OF CERTAIN FINANCIAL INSTRUMENTS

In certain cases, the costs included in certain financial instruments over which sales transactions are carried out, are important, and also, not easily recognizable (i.e. certain fixed-income instruments when the counterparty is the Entity itself, structured financial agreements and certain OTC derivatives).

To reduce the information shortfall, Circular 1/2018 establishes that retail clients must receive the warning below when the cost of the financial instrument is higher (which is defined as the difference between the cost including the explicit commissions and the estimated current value) than 5% of the total, or 0.6% multiplied by the outstanding years until expiry. The warning is as follows:

“Warning

In line with the estimate of the current value of the financial instrument YYY (the financial instrument should be identified) carried out by ZZZ (name of the entity which has calculated the estimate), and considering all the costs of the transaction, you are handling an approximate total cost of X% (the percentage must be included) of the current estimated value of this instrument/the notional value of this instrument (the corresponding option will be included depending on the type of instrument)”.

The Entity must collect the retail client’s signature, which must be added next to the abovementioned warning.

Furthermore, Circular 1/2018 establishes how the outstanding life of the instrument should be calculated, as well as the definition of the current value.

SINGLE TRANSITORY PROVISION

The Entities that have retail clients’ financial instruments which are considered highly complex or equity instruments or bail-in eligible instruments, must identify them clearly as such. This must be done in the first periodical excerpt they must submit to their retail clients once Circular 1/2018 enters into force, and include the following warnings:

“Warning:

This extract identifies certain financial instruments that are equity instruments or bail-in eligible liabilities. In the event of the resolution of the issuer of such financial instruments (the process

applicable when the issuer is insolvent or it is expected that it will become insolvent in the near future and due to public interest and for financial stability reasons it is necessary to avoid its insolvency), such product could be converted into shares or its principal reduced which would result in its holders being able to make losses in their investment.”

“Warning:

As of XX/XX/XXXX (date this Circular enters into force), it is mandatory that the National Securities and Exchange Commission (CNMV) warn before any contracting that it considers that certain financial instruments are not simple and could be difficult to understand and therefore because of the complexity of the product its acquisition is not suitable for retail clients in general. This extract identifies the instruments included in this obligation.”

It will not be necessary to make the abovementioned references when the retail client has already been informed, in accordance with the ESMA statement published on MiFID practices for firms selling financial instruments subject to the BRRD resolution regime (ESMA/2016/902).

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