FSMA

FINANCIAL SERVICES AND MARKETS AUTHORITY

Communication

**FSMA_2017_04 of 30/01/2017**

# Position of the FSMA on the application of the Belgian rules on unfair contract terms to some clauses as part of the offer of investment instruments

**Scope:**

This Position is intended for companies that offer investment instruments to consumers within the territory of Belgium.

**Summary/Objectives:**

The Position contains a series of recommendations and interpretations by the FSMA on the subject of the application and scope of the provisions in Book VI "Market practices and consumer protection" of the Economic Law Code (ELC) on unfair terms in contractual relationships between issuers of investment instruments and investors who can subscribe to these investment instruments as consumers within the meaning of the ELC.

**Structure:**

1. Introduction
2. Recommandations in respect of public offers within the territory of Belgium
3. Position on the application of the Belgian rules on unfair contract terms

## 1. Introduction

- The Position contains a series of recommendations and interpretations by the FSMA on the subject of the application and scope of the provisions on unfair terms in contractual relationships between issuers of investment instruments and investors who can subscribe to these investment instruments as consumers within the meaning of the ELC.

  These provisions on unfair contract terms indeed also apply to "financial services" as referred to in Article I.8, 18° of the ELC. This broad term also comprises investment instruments. The legislators did not seek to make any further distinction based on the type of investment instrument.

- The Position is based principally on the experience of the FSMA gained via its ex ante supervision of information disclosed when offering investment instruments to the public. This does not prevent the interpretations being relevant to non-public offers of investment instruments (or to public offers of investment instruments that are not subject to the FSMA's supervision), if consumers (within the meaning of the ELC) are able to subscribe to them.

- This supervisory practice has revealed that a number of contract terms which are repeatedly included in the Terms & Conditions of structured notes, as reflected in the prospectuses used for their public offer within the territory of Belgium, could be problematic in light of the provisions regarding unfair contract terms, in particular what are referred to by the legislators as "black terms", as listed under Article VI.83 of the ELC. The black terms in Article VI.83 of the ELC, the so-called "black list", are unfair in all cases and therefore unauthorized.

  Given that structured notes have a fixed term, they are assessed on the basis of the black terms that apply to fixed-term contracts. These are, in particular:

  - terms that allow the issuer unilaterally to alter essential characteristics of the product - Article VI.83, 4º of the ELC;
  - terms that allow the issuer unilaterally to end the fixed-term contract without compensating the consumer - Article VI.83, 10° ELC;
  - terms that provide for the transfer of the contract - Article VI.83, 31° of the ELC.

  The assessment of the contract terms, which is carried out in the first instance on the basis of the black list, is supplemented by a test based on the general principle under Article I.8, 22º of the ELC. In accordance with this general principle, it is important to determine whether or not the term creates a "significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer". On the one hand, it does not follow that just because a contract term is not unauthorized under the black list, it is automatically fair under the general principle. Contract terms that do not strictly fall under the black list can indeed still be found to be unfair based on the general principle. On the other hand, the general principle is also used as a guideline to interprete the meaning of the black listed contract terms for such investment instruments. Given the nature and characteristics of investment instruments, the black listed contract terms (which are always unfair) are indeed not always easily applicable to the contractual clauses included in the Terms and Conditions.

- Structured notes are to be considered investment instruments the price of which is dependent on fluctuations on the financial markets. As a result, the black terms listed in Article VI.83, 3º (discretionary increase of the price or amendment of the conditions to the detriment of the consumer) and 5º (unilateral setting or altering of a product's delivery time) of the ELC pursuant to Article 5, § 2 of the Royal Decree of 23 March 2014[1] do not apply to these notes.

  The recommendations and interpretations formulated in this Position are also relevant to unstructured debt instruments that offer the right to payment of the face value at maturity (e.g. plain vanilla bonds, senior notes). These investment instruments can be defined as products with a fixed term, the price of which is dependent on fluctuations on the financial markets. Where a recommendation or interpretation applies specifically to this type of investment instrument, it is explicitly mentioned. In this way, consistency is sought in the implementation of the legal provisions that apply without distinction to all fixed-term investment instruments.

  Although investment instruments with no fixed term (for example, financial derivatives such as CFDs, etc.) are not directly covered by this document, some of the recommendations and interpretations, especially those pertaining to the notion of force majeure, apply *mutatis mutandis* to this type of investment instrument.

- Designed to be a dynamic document, this Position can be fine-tuned and supplemented over time in order to take into account new changes, insights and questions as regards the application of the provisions on unfair contract terms and, if the FSMA considers it desirable, it can be extended to cover other types of financial products.

  As this document contains only recommendations and interpretations by the FSMA, it does not constitute a regulatory document. These recommendations and interpretations are in no way intended to derogate from the ultimate jurisdiction of the courts for the assessment of the fair or unfair nature of these contractual clauses.

  Although the provisions governing unfair contract terms apply to investment instruments since the introduction of Book VI into the Economic Law Code by the Law of 21 December 2013, and this Position contains only recommendations and interpretations, the FSMA will take into account that it was not yet possible to take these recommendations and interpretations into consideration prior to the publication of this Position.

[1] Royal Decree on taking special measures and on derogations from certain provisions of Book VI of the Economic Law Code for specific categories of financial services.

## 2. The FSMA recommends:

- where an offer is made on the basis of a prospectus that was approved by the competent authority of another Member State of the EEA (known as a “passported” prospectus), that:

  - if the passported prospectus is a base prospectus, the unfair contract terms contained therein be declared in the **final terms** of the public offer in Belgium not to be applicable; to that end, it is recommended that the issuers provide for this option in the passported base prospectus;

  - if, notwithstanding the prohibition, unfair contract terms are nevertheless included in the Terms and Conditions included in the passported prospectus, the **advertisements** (or other documents and announcements) relating to a public offer in Belgium is addressed (also or exclusively) to consumers and is published by the issuer or a distributor acting with the consent or cooperation of the issuer:

    - a declaration be included stating that the issuer commits to complying with the provisions of the ELC, and especially those pertaining to unfair contract terms; if the advertisement is published by a distributor, this commitment on the part of the issuer is to be included in the advertisement with the issuer’s consent;

    - such unfair contract terms be identified and the aforementioned declaration be amended to state that these do not apply.

For the sake of **readability**, (i) the summary of the prospectus or base prospectus and (ii) the chapter on the contractual terms (the Terms & Conditions) of the prospectus or base prospectus should include a plain and intelligible overview of the rights of both parties and the ways in which these can be exercised, in such a way as to enable the consumer to understand the scope of the conditions and assess the economic consequences of the clauses.

## 3. Position of the FSMA on:

### Force majeure

a. **Force majeure** can only exist in the case of one party’s insurmountable inability to meet its commitments, for which that party is not accountable.

   On condition that the continuance of the investment instrument is thereby rendered definitively impossible, the FSMA considers that the following may, for example, be considered force majeure: issues with the continuance of the underlying in the event of bankruptcy of the issuer of (one or more components of) the underlying, or cases of illegality (such as events of “change in law”, “nationalization” or “regulatory action”), cases of the necessary information no longer being available (such as events of "reporting disruption") or changes in the investment policy or other similar changes (such as events of "strategy breach", "fund modification", "index modification" or "index disruption") pertaining to (one or more components of) the underlying.

By contrast, situations that lead to the continuance of the product under similar conditions being more expensive or more difficult (but not definitively impossible) for whatever reason (internal or external), or occurrences and risks that are inherent in the issuer's activity of product development, cannot, in the FSMA's view, be considered cases of force majeure.

For these reasons, situations which, according to the FSMA, do not constitute force majeure include — but are not limited to — the following:

- a change in the tax regime which leads to a higher cost for the issuer ("tax event");
- an increase in the costs of continuance of the hedging instrument ("increased cost of hedging");
- a decrease in the volume of notes in circulation ("clean-up");
- a considerable loss in the value of the underlying ("stop loss").

b. **Force majeure** prevents the issuer from being able to meet its commitments and is **a legitimate reason in general law for the issuer** unilaterally to terminate a contract and therefore to **proceed to early repayment at market value**, even if there is no term that explicitly provides for this right**.**

A contract term in which the issuer explicitly reserves the right, in the case of force majeure, to proceed to early repayment of the investment instrument (whether fixed term or not) at least at the market value[2] at that time is, therefore, neither unauthorized under the black list (see Article VI.83, 10°, and 11° of the ELC) nor unauthorized under the general principles.

A contract term in which the issuer reserves the right, in the case of force majeure, to proceed to early termination of the contract with no repayment to the consumer at (at least) the market value at that time does, however, create a significant imbalance in the parties' rights and obligations to the detriment of the consumer, and is therefore unauthorized (at least) under the general principles (Article I.8, 22º of the ELC in conjunction with Article VI.82 of the ELC).

[2] Market value (or fair or real value) is used to mean the value or price that would be received to sell an asset or transfer a liability between parties who are independent, knowledgeable and able and willing to transact. In an active market, market values are the observable bid and ask prices. In the absence of recently observable market prices, the market value of an asset or liability is determined using a generally accepted (valuation) method.

c. A contract term in which the issuer reserves the right to charge additional costs to the consumer for early repayment (even) in the case of force majeure creates a significant imbalance in the parties' rights and obligations to the detriment of the consumer. Such a contract term enables an issuer to profit by keeping part of what is due to the consumer and is therefore unauthorized under the general principles (Article I.8.22º of the ELC in conjunction with Article VI.82 of the ELC). "Additional costs" refer to costs other than those that are unavoidable in order to be able to repay the consumer the market value to which the consumer (and not the issuer) is entitled.

d. Force majeure prevents the issuer from meeting its obligations. **Force majeure does not however entitle the issuer unilaterally to alter essential characteristics of the contract**, except with the consent of the consumer or under the conditions mentioned below (see below under letters f, g and h).

**Unilateral alteration of the essential characteristics of the investment instrument (Article VI.83, 4º of the ELC).**

e. For the purposes of Article VI.83, 4º of the ELC, the FSMA is of the opinion that **at least the following characteristics are essential for consumers who invest in a structured product:**

   (i) the yield (coupon structure);

   (ii) the underlying asset which is a determining factor for the yield;

   (iii) whether there is full or partial repayment of the investment at maturity (i.e. no capital protection, partial capital protection or full capital protection);

   (iv) the party or counterparty on which the investor is exposed to credit risk;

   (v) the term of the structured product.

   As a result, contract terms which entitle the issuer to alter unilaterally these essential characteristics of the investment instrument are in principle unauthorized (Article VI.83, 4º of the ELC; see below, however, under letters f, g and h for cases to which according to the FSMA this prohibition does not apply).

f. Contract terms that provide for characteristics, even essential ones, to be changed by a **majority vote of the holders of investment instruments** (following the example of the provisions of the Companies Code for the general meeting of bondholders) are, according to the FSMA, in principle **not unauthorized** by Article VI.83, 4º of the ELC because they do not entitle the issuer unilaterally to alter the essential characteristics of the product (unless the concrete circumstances indicate that the issuer itself has thereby *de facto* assumed the right to impose this decision unilaterally).

g. Contract terms in which the issuer reserves the right to **offer the consumer the choice of an amended contract**, **as an alternative to early repayment at market value** which the issuer may proceed to make **in the case of force majeure**, are, according to the FSMA, **not unauthorized** by Article VI.83, 4º of the ELC. Such a contract term does not, after all, entitle the issuer unilaterally to alter the essential characteristics of the product, but rather to alter them only with the consent of the consumer.

h. The FSMA is of the opinion that **contract terms in which the issuer reserves the right unilaterally to alter the essential characteristics** of the product **may, under certain conditions, be acceptable.**

   These conditions are aimed at clarifying the application of the rules on unfair contract terms to investment instruments, whereby account must be taken of the need to bear in mind, in the interpretation of Article VI.83, 4º, of the ELC, both the intrinsic characteristics of investment instruments and the goal of the legislation (which is also reflected in the general principle). **The cumulative conditions** are the following:

   (i) the issuer has this right only:

   a. in the case of force majeure; or

   b. in circumstances which significantly alter the economics of the contract as initially agreed between the parties and for which the issuer is not accountable, even if they do not make the performance of the contract definitively impossible (and therefore do not constitute force majeure).

   ⇨ The FSMA is of the opinion that issues, for example, with the continuance of the underlying in the event of bankruptcy of the issuer of (one or more components of) the underlying, or cases of illegality (such as events of "change in law", "nationalization", or "regulatory action"), cases of the necessary information no longer being available (such as cases of "reporting disruption"), changes in the investment policy or other similar changes (such as events of "strategy breach", "fund modification", "index modification" or "index disruption") pertaining to (one or more components of) the underlying, which nevertheless do not make the continuance of the investment instrument definitively impossible, meet these conditions.

   ⇨ The FSMA is of the opinion that cases that are intrinsic to the issuer's activity of product development do not meet these conditions (as is the case for example with "increased cost of hedging" and "hedging disruption"). A contract term that entitles the issuer unilaterally to alter the essential characteristics of the product in such cases creates a significant imbalance in the parties' rights and obligations to the detriment of the consumer and is therefore unauthorized under the general principles (Article I.8.22º of the ELC in conjunction with Article VI.82 of the ELC).

(ii) The contract term must be drawn up in a plain and intelligible manner.

(iii) The implementing terms do not create a significant imbalance in the parties' rights and obligations to the detriment of the consumer.

⇨ This requirement means that an issuer must take all reasonable measures and make all reasonable efforts (best-efforts obligation; increase in cost or lack of commercial viability in the continuance of the product are not acceptable reasons for a more substantial change or for a change that is more disadvantageous to the consumer) to continue the product under similar conditions so that any alteration made to the characteristics of the product which are in principle essential to the consumer is not substantial and is aimed at restoring the economy of the contract as initially agreed upon.

For example, if information on the value of the underlying of a structured product or a component thereof is no longer published, and as a result thereof the issuer is no longer able to calculate the value of the structured note, if the issuer of a share from the underlying index is declared bankrupt or if there is a change in the investment policy of an underlying fund, the issuer may replace the initial underlying or component thereof with an underlying or component thereof that is as similar as possible.

⇨ this requirement also means, in the FSMA's opinion, that where the issuer reserves the right, in the case of a particular event, to change a structured note with capital protection in such a way that the investor, at maturity, is paid the sum of the market value (at the time of the decision to make the unilateral change) of the savings component and of the derivative embedded in the contract, plus interest (i.e. "monetization", see below), this clause is **not** acceptable because it substantially alters the essential characteristics of the product. After all, in such a case, the investor loses the potential for capital gain based on the further evolution of the underlying (which is an essential characteristic of the product: see above under point e).

Nevertheless, the FSMA does deem a "monetization" contract term acceptable under certain circumstances (see below on "early termination" under letter i), section (iii)).

(iv) The consumer may not be charged any costs (such as settlement costs) to change the agreement.

## Unilateral early termination of fixed-term investment instruments (Article VI.83, 10º of the ELC)

i. Where the contractual documents entitle the issuer **unilaterally to terminate the contract early**, **other than in cases of force majeure**, the investor must be given the right to a compensation that is intended to **compensate in full** (including loss suffered and loss of profit, without this compensation having to constitute a type of "punishment" for the issuer).

The FSMA is of the opinion that such unilateral early termination with the right to compensation, other than in cases of force majeure, is **possible only when a number of conditions are met**.

These conditions are based on the need to ensure that a contract term is admissible under both the "black list" (and in particular Article VI.83, 10º of the ELC) and the general principle. **The cumulative conditions** are the following:

(i) The issuer has this right only in an event which significantly alters the economics of the contract as initially agreed between the parties and for which the issuer is not accountable.

⇨ The FSMA is of the opinion that issues with the continuance of the underlying in the event of bankruptcy of the issuer of (one or more components of) the underlying, or cases ofillegality (such as events of "change in law", "nationalization", or "regulatory action"), cases of the necessary information no longer being available (such as events of "reporting disruption"), changes in the investment policy or other similar changes (such as events of "strategy breach", "fund modification", "index modification" or "index disruption") pertaining to (one or more components of) the underlying, which nevertheless do not make the continuance of the investment instrument definitively impossible, meet these conditions.

⇨ The FSMA considers that changes in external circumstances, such as a change in the tax regime ("tax event"), or cases which make the investment instrument no longer suitable for its initial purpose, which from the outset was clearly communicated and which is accompanied by a compensation to the benefit of the consumer (such as a "capital disqualification event" or "loss absorption disqualification event"), meet these conditions.

⇨ The FSMA is of the opinion that cases that are intrinsic to the issuer's activity of product development do not meet these conditions (as is the case for example with the events of "increased cost of hedging" and "hedging disruption"). A contract term that entitles the issuer to the right unilaterally to repay the product early in such cases creates a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer, and is therefore unauthorized under (at least) the general principles (Article I.8.22º of the ELC in conjunction with Article VI.82 of the ELC).

⇨ The FSMA is of the opinion that situations that entitle the issuer to terminate the product at its own discretion, such as in the case of "clean-up" and "stop-loss" clauses, are unauthorized because they create a significant imbalance between the parties' rights and obligations, to the detriment of the consumer.

(ii) The contract term must be drawn up in a plain and intelligible manner.

(iii) The implementing terms do not create a significant imbalance in the parties' rights and obligations, to the detriment of the consumer.

⇨ The FSMA considers that where the investor in a structured note with (total or partial) capital protection, at the time of the decision to proceed to early repayment (hereinafter the "activating event"), is repaid at (i) the market value of the product (i.e. the sum of the market value of the savings and derivative components) or (ii) the face value of the capital protection amount, whichever is the highest ("best-of" formula), it can be deemed that compensation exists and, moreover, no significant imbalance is created to the detriment of the consumer.

⇨ The FSMA considers that where the investor in a structured note with (total or partial) capital protection is offered, at the time of the activating event, the choice between

– the payment at maturity of at least the amount obtained using the formula stipulated below ("monetization"), which in particular implies the repayment of at least the capital protection amount at maturity:

$$(S + D) * (1+r)^n$$

where

S = the market value of the savings component on the day of the activating event,

D = the market value of the derivative component on the day of the activating event,

where account is taken of the accrued unpaid interest,

r = the annual interest rate that the entity on which the consumer is exposed to the principal (more than 50%) credit risk (depending on the circumstances, the issuer, guarantor or any other party involved in the construction) offers on the date of the activating event on a debt instrument with the same maturity as the remaining maturity of the terminated structured product ("funding rate", which also matches the discount rate used when determining S), from that date until maturity,

n = the remaining maturity expressed in years.

and

– the early repayment at market value of the product (i.e. the sum of the market value of the savings and derivatives component) at that time,

the clause is fair in the light of both Article VI.83, 10° of the ELC (because the consumer receives compensation in the case of early repayment, albeit without "punishment" to the issuer) and Article VI.83, 4° of the ELC (because the alteration that implies monetization is not set unilaterally by the issuer but rather at the investor's choice) and, furthermore, because of the alternative offered, no significant imbalance is created to the detriment of the consumer.

⇨ In structured notes with no capital protection, the FSMA considers that in the case of early repayment at the products' market value (i.e. the market value of the derivative component), the implementing terms are not prejudicial to the contractual balance to the detriment of the consumer.

⇨ The FSMA considers that where the investor in an unstructured debt instrument which gives a right to the payment of face value at maturity ("senior debt", "plain vanilla bonds" etc.) is repaid at the time of the decision to proceed with early repayment at either (i) the market value of the product or (ii) the face value of the debt instrument, whichever is the highest ("best-of" formula), it can be considered that the consumer is compensated, albeit without punishment to the issuer, and moreover no significant imbalance is created to the detriment of the consumer.

(iv) The consumer may not be charged any costs (such as settlement costs) for early termination of the agreement.

(v) At the time of the early termination the investor is refunded the costs paid to the issuer (such as structuring fees) pro rata in the following proportion:

$$\frac{\text{Total term initially set - expired term at the time of the early repayment}}{\text{Total term initially set}}$$

**<u>Contract terms that provide for the option to substitute another party for the issuer - Article VI.83, 31° of the ELC)</u>**

j. In some cases, the option is provided for an issuer to substitute another party for itself. Pursuant to Article VI.83, 31° of the ELC, a contract term that provides for the option to transfer the contract, as a result of which the guarantees to the consumer could be reduced without the consumer's consent, is also unauthorized. Account must moreover be taken of the general principles.

The possibility of substituting someone for the issuer can be deemed acceptable provided that:

(a) the substitution occurs due to an exceptional event that substantially alters the situation of the issuer as compared with the time of entry into the contract and is described in a plain and intelligible manner in the contractual documentation; and

(b) the guarantees given to the consumer are not reduced without the consumer's consent.

*Condition (a)* is not met if the issuer is able to substitute another issuer at its own discretion without there being exceptional circumstances to warrant such substitution. Such unlimited possibilities for the issuer to withdraw from its own obligations, even if it substitutes another debtor for itself, do after all create a significant imbalance in the parties' rights and obligations arising under the contract to the detriment of the consumer, and are therefore unauthorized, at least under the general principles (Article I.8.22° of the ELC in conjunction with Article VI.82 of the ELC).

*Condition (a)* can, by contrast, be met if the issuer reserves this right in cases of legal restructuring (such as dissolution and winding up, mergers, etc.) involving, inter alia, the issuer.

Substitution in the case of events other than those described under *condition (a)* is possible only where the issuer continues to exist and irrevocably and unconditionally guarantees compliance with the payment obligations of the substitute issuer.

*Condition (b)* is met, for example, if the contract term provides that the substitute issuer must form part of the same group of companies and must have at least the same long-term rating as that of the issuer at the time of the transfer, and furthermore provides additional guarantees for the consumer, such as at least:

- the condition that there are no payment arrears or that there are no indications of imminent payment arrears or of payment problems or repayment problems for the principal and interest;

- the commitment by the substitute issuer to hold investors harmless from disadvantageous financial consequences of a difference in the tax and regulatory regime which the substituting issuer is or may be subject to and not to pass on to investors the costs associated with the substitution;
- the condition that any guarantee issued in terms of the issuer's payment obligations vis-à-vis investors also applies to the substitute issuer's payment obligations vis-à-vis these investors.

**Early redeemable debt instruments - "callable" and "autocallable" products**

k. Cases of unilateral early redemption ("callable" and "autocallable" products) could be deemed to form the subject matter of the contract ("main subject matter") on condition that the product is distributed as such, that this product feature is plainly and intelligibly formulated and that this feature is accompanied by compensation to the benefit of the consumer[3]. This product feature should also be clear from the information contained in the advertisements and other documents and announcements used as part of the distribution of that product.

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Annex: FSMA_2017_04-1 / Overview of conditions in order for clauses to be acceptable

[3] See the FSMA's 2014 Annual Report, p. 138-139.