

Belgian FSMA's position on unfair terms in financial instruments

February 2017

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The Belgian Financial Services and Markets Authority (**FSMA**) published a communication regarding the application of the unfair terms legislation in the context of the offering of securities to consumers (the Communication)¹.

- **Issuers** and **distributors** will have to carefully review the issuance, marketing and distribution of financial products to Belgian consumers. The Communication is relevant to structured notes as well as non-structured notes, retail issues as well as private placements and passported as well as non-passported issues.
- **Issuers** and **arrangers** will have to review the structure and content of offering documents, e.g. the terms and conditions in the base prospectus, in order to be able to comply with the Communication.
- The terms and conditions of specific products will have to be reviewed in light of the Communication, especially modification clauses, call options and substitution clauses. Certain **typical clauses** such as a tax call at par, a clean-up call following change of control, and a discretionary issuer's call, are affected by the Communication.

2. General considerations

2.1 Background

The legal provisions in the Code of Economic Law prohibiting unfair terms apply to "investment instruments"². An unfair term is null and void, and inclusion of an unfair term could render the entire contract null and void. The Code of Economic Law does not contain clear guidance regarding the application of these provisions to the terms and conditions of investment instruments, e.g. structured notes. Hence the importance of the Communication.

The Communication is part of a broader trend targeting products that are sold to retail investors. Last year, for example, the FSMA introduced a strict legal framework for the distribution of OTC Derivatives (such as binary options and CFDs), restricting the distribution of such products to retail consumers. Previously, the FSMA had already introduced a voluntary moratorium on the distribution of certain complex structured products, and strict marketing guidelines regarding the marketing of financial products across various product types (including deposits, securities, funds and insurance products).

¹ http://www.fsma.be/~media/Files/fsmafiles/circ/en/2017/fsma_2017_04.ashx (English version of the Communication)

² Article I.8, 18° Code of Economic Law

2.2 Scope of application

(a) Structured notes and other financial instruments

The scope of application of the Communication is broad, as the following instruments are captured:

- *Structured notes*: the FSMA has drafted the Communication mainly based on its review of the offers of structured notes, i.e. notes offering a return linked to various underlying values (note that the Communication does not include a definition of the concept of structured notes).
- *Other non-structured debt instruments*: the Communication is also applicable to non-structured debt instruments, instruments with a repayment of a nominal value at maturity date, e.g. plain vanilla bonds or senior notes.
- *Investment instruments without a fixed duration*: financial derivatives such as CFD or warrants, for example. While these are not directly targeted by the Communication, according to the FSMA some recommendations and interpretations can be applied mutatis mutandis to these products.

(b) Public offer or private placement

The Communication applies to public offers as well as private placements. The Communication is relevant if “consumers” within the meaning of the Code of Economic Law can subscribe to the investment instruments. Consumers are natural persons acting outside their trade, business or profession. There are no exemptions, e.g. for (i) high net worth individuals or (ii) based on a minimum investment amount.

(c) Passported offers, governing law

The Communication applies as soon as investment instruments are offered to consumers on the Belgian territory and is also applicable to passported issues. The FSMA does not distinguish between Belgian and foreign law governed terms and conditions. In this respect, further clarification will be required.

2.3 Legal status of the Communication

The Communication consists of “recommendations and interpretations” by the FSMA and cannot be considered as a binding regulation. However, the FSMA has supervisory powers to review offers of investment instruments, including their compliance with the Code of Economic Law³. While there is in principle no “a priori” review of the terms and conditions by the FSMA, the FSMA will take the recommendations into account as part of its a priori review of marketing materials and/or prospectuses for a public offer. In the context of legal disputes with individual investors, courts are not legally bound by the determinations made by the FSMA.

3. Content of the Communication – overview

3.1 Relevant provisions

In line with the European Unfair Terms Directive, there are two types of “unfair terms” prohibited pursuant to the Code of Economic Law:

- *Grey clauses*: these are the clauses causing a significant imbalance in the parties’ rights and obligations under the contract, to the detriment of the consumer.
- *Black clauses*: these are the clauses that are specifically identified as unfair terms in the Code of Economic Law.

³ Article VI.11 § 2 Code of Economic Law. Note that the administrative supervisory power of the FSMA is a concurrent power with the Belgian Federal Agency Economic Affairs. This federal agency is not formally bound by the FSMA Communication.

The Communication is specifically concerned with three types of clauses that qualify as a black clause:

- *terms allowing unilateral amendment of essential features of a contract*⁴,
- *unilateral termination*⁵: (*absent force majeure*); and
- *contract transfers*⁶.

There is interplay between the application by the FSMA of the black clauses and the grey clauses: the requirement for balanced clauses (prohibition of grey clauses) influences the interpretation by the FSMA of black clauses in the context of investment instruments.

3.2 Unilateral amendment of the essential features of a contract

Essential features of a structured note are (i) the structure of the coupon (the yield), (ii) the underlying asset of the structured note, (iii) the capital protection, (iv) the counterparty and (v) the term of the note. Clauses allowing the issuer to unilaterally amend⁷ the essential features of a contract are in principle prohibited, unless the following cumulative conditions are fulfilled:

(a) Force majeure or significant change to the overall economy of the contract

There is *force majeure* or another event that significantly alters the overall economy of the contract (provided that such event is not attributable to the issuer); events that could be taken into account are for instance, illegality, change of law, regulatory action with respect to an underlying feature of the structured note. Increased cost of hedging or hedging disruption would not qualify as *force majeure*.

(b) Clear drafting of the clause

The clause allowing for the amendment must be drafted in a clear and intelligible manner.

(c) No significant imbalance between the rights and obligations of the parties

The application of the clause must not result in a significant imbalance between the rights and obligations of the parties to the detriment of the consumer. The issuer must take all reasonable measures and undertake all reasonable efforts to ensure that the product can be continued under similar circumstances.

(d) No costs due by the consumer

No costs (such as for instance costs of unwinding a hedging arrangement) must be imposed on the consumer.

3.3 Unilateral termination of investment instruments with a definitive duration

In a case of force majeure, unilateral termination by the issuer is allowed, at market value, without imposing additional costs on the investors. Absent force majeure, the issuer is in principle not allowed to unilaterally terminate (call) the product unless the following cumulative conditions are met:

(a) Significant change to the overall economy of the contract

An event occurs that significantly alters the overall economy of the contract (provided that such event is not attributable to the issuer). The FSMA gives an overview of events that could be considered as such an event:

- *certain events affecting its underlying nature*, e.g. illegality, change in law, nationalization, regulatory action, reporting disruption or strategy disruption/fund modification;
- *certain changes in external circumstances*: changes in the tax regime (“tax events” for purposes of tax calls) or events that render the instrument no longer suitable for the initial purpose (e.g. capital disqualification events or loss absorption disqualification events);

⁴ Article VI.83, 4° Code of Economic Law

⁵ Article VI.83, 10° Code of Economic Law

⁶ Article VI.83, 31° Code of Economic Law

⁷ Amendments agreed upon by a noteholders’ meeting are allowed as such amendments do not result from a unilateral amendment by the issuer.

However, events “inherently linked to activity of the issuer” (e.g. increased cost of hedging or hedging disruption) will not be accepted. The FSMA will in principle not accept events that would grant the issuer a discretionary right to call the notes.

(b) Indemnification of the consumers and no significant imbalance between the rights and obligations of the parties

The application of the clause must not result in a significant imbalance between the rights and obligations of the parties to the detriment of the consumers, and the consumers must be indemnified. The Communication includes further guidance regarding the calculation of this indemnification.

Capital protected structured notes	<p>“Best-of formula”: at the time of the call, repayment of the greater of (i) the market value of the product (at that time) and (ii) the nominal capital protected amount; or</p> <p>At the choice of the investor: repayment at maturity following a monetization formula (as set out in the Communication) or early repayment of the market value.</p>
Structured notes without capital protection	Repayment at market value
Non-structured notes (with the repayment of a fixed nominal amount at maturity)	“Best-of formula”: repayment of the greater of (i) the market value of the product (at that time) and (ii) the nominal amount of the product

(c) No deduction of costs and pro rata compensation investor’s cost

No costs should be deducted and a pro rata compensation should be paid for the costs paid by the investor to the issuer (e.g. structuring costs).

3.4 Substitution of the issuer

The Communication provides further guidance regarding the conditions under which the substitution of the Issuer is allowed. In principle, this will only be allowed in extraordinary conditions and to the extent it does not result in weakening consumer protection (e.g. the clause must require that the new issuer has at least the same rating as the substituted issuer). This means that the FSMA will not accept a discretionary right to substitute the issuer. However, substitution would be allowed e.g. in the case of legal restructuring (mergers, liquidations).

3.5 Callables and autocallables

According to the FSMA, a callable or autocallable⁸ feature can qualify as a “key feature” of the product (*clause essentielle/kernbeding*). Such key features will not be deemed to be unfair terms. To qualify as a “key feature” several requirements must be met:

- the product must be clearly marketed as callable or autocallable (the key feature must be referred to in all marketing materials for the product and will also have to appear prominently on the front page of the prospectus/offering circular);
- the feature of the product must be explained in a clear and easily understandable manner; and
- the feature must be reflected in the pricing of the product (there is no further concrete guidance available as to how this must be assessed).

⁸ Autocallable notes are designated to be automatically called if e.g. a reference value is at or above an initial level on an agreed observation date.

3.6 Impact for typical calls

Issues on the Belgian market typically included the following features:

Tax call at par	No longer accepted	The issuer would have to repay the bonds at the greater of (i) the market value of the product (at that time) or (ii) the nominal amount.
Clean-up call⁹	No longer accepted	Deemed to create an imbalance to the detriment of consumers
Discretionary issuer call (against payment of make-whole amount):	No longer accepted, except if "key feature"	Must be marketed as key feature and reflected in the pricing

3.7 Practical implementation of the recommendations

If the passported prospectus is a base prospectus, the final terms for a specific issue offered in Belgium should state that any unfair terms referred to in the base prospectus do not apply; it should be ensured that the base prospectus allows the option for the issuer to state that the relevant provisions do not apply for a specific issue.

Should unfair terms nevertheless be included in the terms and conditions that are part of the passported prospectus, the FSMA recommends that the marketing documentation include a statement whereby the issuer undertakes to comply with the provisions of the Code of Economic Law, in particular the provisions with respect to unfair terms. The statement must identify the relevant unfair terms and expressly state that these do not apply to the offer to Belgian consumers.

The FSMA does not further comment on the legal status of such statements and declarations. Issuers should review the structure of their offering documents to determine how they can comply with the FSMA recommendations. For instance, for a Prospectus Directive-compliant Prospectus, the regulator may not accept amendments to the terms and conditions through a prospectus supplement.

4. Timing

The unfair terms provisions included in the Code of Economic Law are applicable since 21 December 2013. However, the FSMA acknowledges that issuers could not yet take into account the recommendations and interpretations that are set out in the Communication prior to its release on 6 February 2017.

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⁹ Issuers often grant the investors an "investor put" upon a change of control and provide for a discretionary issuer's call permitting the issuer to call the notes if a certain high percentage of the bondholders have exercised the put upon the change of control.