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PRIIPs

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The European Commission's work on packaged retail investment products or "PRIIPs" started a long time ago but now, at last, in April 2014 we have the provisional version of the adopted text post approval of the proposals by Parliament on 15 April. The question is now whether the settled initiatives will go far enough in order to level the playing field between comparable products – it mainly addresses selling practices which can result in only a partial levelling of the playing field.

Background

There has been longstanding commentary on the need where economic characteristics of a product are similar for there to be rules governing their sale to be substantially similar, whether they are sold in the banking, insurance or securities sector. In the absence of EU-wide regulation on this wide range of PRIIPs products, individual countries had inevitably started to take their own initiatives for their own domestic markets and this EU Commission PRIIPs initiative is an attempt to standardise the approach across the EU.

Whilst it may be the case that really only UCITS are currently sold on a major basis cross-border with the UCITS passport, there is a prospect of alternative investment funds now being sold pursuant to the AIFMD marketing passport, and this PRIIPs initiative is designed to establish a commonality of regulatory approach across a much wider range of products. The main content of the Regulation regarding key information documents for retail investment products is derived from the UCITS key information document template.

A working document of Commission Services (DG internal market) was issued in November 2010 which was a consultation by Commission Services on legislative steps for the packaged retail investment products initiative. That consultation represented the views of Commission Services and did not represent or prejudice the contents of further work of the Commission. It flagged up two key market failings to be addressed for the European retail investment markets concerned:

- the information provided to investors by those producing and selling investments to them; and
- conflicts of interest of those producing and selling investments and the interests of their client.

The July 2012 Commission proposed Regulation focused on the first of these failings - the provision of information pre-sale. It is this proposal which has now developed into a new Regulation.

What is a PRIIP?

The Article 4 definition section has been amended in recent drafting changes. The finalised text includes the following definitions:

- "a packaged retail investment product" or "PRIIP": "an investment, including instruments issued by SPVs as referred to in Article 14(26) of [the AIFMD] where, regardless of the legal form of the investment, the amount repayable to the investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the investor".
- an "insurance-based investment product": "an insurance product which offers a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations."
- "a packaged retail and insurance based investment product" or "PRIIP": any product that falls into these definitions of PRIIP or insurance based investment product.

These additional definitions were required in order to differentiate some of the issues regarding insurance products mentioned below. The key information document initiative now relates to the widely defined category of PRIIPs.

Note that the proposals have therefore evolved considerably. The 2009 Commission communication and related workshop issues paper looked at criteria as to the economic functioning of the products such that PRIIPs were to be identified as capital accumulation products where the returns in a product are generated through indirect exposure to underlying assets such that investor carries all of the investment risk or at least some of that risk. The Regulation now, as the 2012 proposed Regulation explained, "operationalizes" this focus on packaged investments via reference to the indirectness of holdings of assets.

The definition should include products with capital guarantees and those where, in addition to capital, a proportion of the return is also guaranteed; investment funds whether closed or open ended, including UCITS; all structured products whatever their form (for example packaged as insurance policies, funds, securities or banking products), insurance products whose surrender values are determined indirectly by returns on the insurance company's own investments or even the profitability of the insurance company itself as well as derivative instruments.

The 2012 Explanatory Memorandum indicated that the following products are not covered by the proposed Regulation:

- products where the precise rate of return is set in advance of the entire life of the product (because then there is no investment risk);

- plain shares and bonds insofar as these do not contain a mechanism other than a direct holding of the relevant assets;
- deposits which are determined by an interest rate (which are not structured);
- insurance products that only offer insurance benefits such as pure protection or non-life insurance products which provide no surrender value that is exposed to fluctuations in the performance of one or more underlying assets or reference values;
- occupational pension schemes governed by Directive 2003/41/EC or Directive 2009/138/EC; and
- pension products for which a financial contribution from the employer is required by national law where the employee has no choice as to the pension product provider.

It is recognised that it might be premature to determine the position particularly as regards Pillar II pensions – but work is ongoing as to addressing transparency and disclosure questions relating to different kinds of defined contribution pensions including personal individual pensions under Pillar III.

Individual and occupational pension products having the primary purpose of providing the investor an income in retirement are excluded from the scope of the Regulation in consideration of their peculiarities and objectives, whereas other individual insurance accumulation or savings products that offer investment opportunities are included.

Having regard to the work undertaken by the European Insurance and Occupational Pensions Authority on disclosure of product information requirements for personal pension products (EIOPA: Towards an EU single market for Personal Pensions, an EIOPA preliminary report to Com, EIOPA – BoS – 14/029, 19 February 2014) and taking into account the specificities of these products, the Commission, within 4 years after the entry into force of the Regulation should assess whether to maintain the exclusion of pension products which under national law are recognised as having the primary purpose of providing the investor with an income retirement and which entitles the investor to certain benefits. In making the assessment the Commission is obliged to consider whether a PRIIPs Regulation is the best legislative mechanism for pensions disclosure or whether other disclosure mechanisms will be more appropriate.

The definitions do not include any reference to the product being intended for retail use. It is now clear that the fact that there is or is not a retail element may only be determined at the point of sale, and the required disclosure will need to be produced whenever a product that falls within Regulation's scope is to be sold to retail investors.

Form and content of disclosures

Section 2 of the Regulation sets out provisions regarding the form and content of the key information document.

The PRIIPs initiative focuses on short, comparable and standardised disclosures across the range of investment products which are within scope. The Commission's aim is that European and retail investors should always receive such disclosures termed "key information documents" or KIDs whichever the investment products they are considering.

Articles 6-9 of the Regulation set out requirements for the form and content of the new KID document. These will be very familiar to many UCITS fund managers. There will of course be slight differences in the required contents of KIDs arising from the differing features of various types of PRIIPs compared with the features of a UCITS type of product, but the general indications in Article 8 of the proposed Regulation are relatively familiar. One can see that they have started with the contents requirements for a KID document for UCITS and worked forward to what they think a PRIIPs version ought to contain.

The fundamental provision in Article 6 is that the key information document shall constitute pre-contractual information and that it shall be an accurate, fair, clear and not misleading document. It shall provide key information and shall be consistent with any binding contractual documents, with the relevant parts of the offer documents and with the terms of conditions of the PRIIP.

It must be a standalone document clearly separate from marketing materials. Moreover it shall not contain cross-references to marketing material. It may though contain cross-references to other documents including a prospectus where applicable, and only where the cross-reference is related to the information required to be included in the key information document by the Regulation. There is an exception to this ban on cross-references where the PRIIP offers a retail investor a range of options for investments, such that all the information required with regard to each underlying investment option cannot be provided within a single concise standalone document, in which case the KID should provide at least a generic description of the underlying investment options and state where and how more detailed pre-contractual information documentation relating to the investment products backing the underlying investment options can be found.

A key point to note is that the KID should be drawn up as a short document written in a concise manner of a maximum of three sides of A4 sized paper when printed, which promotes comparability and is presented and laid out in a way that is easy to read using characters of reasonable size; focused on the key information that retail investors need; and clearly expressed and written in the language and a style that communicates in a way that facilitates the understanding of the information, in particular in language that it is clear, succinct and comprehensible. Jargon is to be avoided.

The title must be "Key Information Document" which must appear prominently at the top of the first page of the document. It shall then be presented with certain required headings in the sequence as set out in Article 8 of the Regulation:

- An introductory explanatory statement underneath the title shall read:

"This document provides you with key information about this investment product. It is not marketing material. The information is required by law to help you understand the nature, risks, costs, potential gains and losses of this product and to help you compare it with other products."

- Identify the product and its manufacturer (and its contact details, regulator) and the date of the document.
- Where applicable, a comprehension alert: *"You are about to purchase a product that is not simple and may be difficult to understand"*.
- **"What is this product?"** - setting out the nature and main features of the product.
- There was consideration of a complexity label which would not replace the MiFIR test for investment firms and suitability for professional retail investors but would be a different test at a different level for this purpose. Under Recital 12(a) it is noted that, as some of the investment products under the scope of the Regulation are not simple and may be difficult for retail investors to understand where applicable the key information document will include the comprehension alert to inform the retail investor of this fact. A product should be regarded as not being simple and difficult to understand especially if it displays one of the following characteristics:
 - it invests in underlying assets that are not commonly invested in by retail investors;
 - it uses a number of different mechanisms to calculate the final return of the investment, creating a greater risk of misunderstanding on the part of the retail investor;
 - the investment's pay-off takes advantage of a retail investor's behavioural biases such as a teaser rate following by a much higher floating conditional rate, or an iterative formula.

The formal complexity label though, proposed in Article 8 (a) of the proposal version published on 21 November 2013, has not been included in the final text.

- **"What are the risks and what could I get in return?"** - a brief description of the risk-reward profile, including a summary risk indicator supplemented by a narrative explanation of the indicator, its main limitations and a narrative explanation of the risks which are materially relevant to the product and

which are not adequately captured by the synthetic risk indicator.

Also this section will include the possible maximum loss of invested capital including as applicable information on whether the investor can lose all invested capital; or whether the investor bears the risk of incurring additional financial commitments or obligations, including contingent liabilities in addition to the capital invested; or, where applicable, whether the product includes a capital guarantee protecting against market risk, the details of its cover and limitations and in particular with respect to timing on when it applies.

- **"What happens if [a product manufacturer] is unable to pay out?"** - requiring a description of whether the related loss is covered by an investor compensation guarantee scheme.
- **"What are the costs?"** – comprising both direct and indirect costs to be borne by the investor including one off and recurring costs presented by means of summary indicators to those costs – and, to ensure comparability, total aggregate costs expressed in monetary and percentage terms to show the compound effects of the total costs on the investment.
- **"How long should I hold it and can I take my money out early?"** – This section should cover, where applicable, whether there is a cooling off period or cancellation period for the product; an indication of the recommended and where applicable required minimum holding period; the ability to make and conditions on any disinvestments before maturity, including all applicable fees and penalties having regard to the risk and reward profile of the product and the market evolution it targets; and information about the potential consequences of cashing in before the end of the term or recommended holding period, such as a loss of a capital guarantee or additional contingencies.
- **"How can I complain?"** – setting out information about how and to whom a client may make a complaint about the product and/or the conduct of the manufacturer and/or the person advising on or selling the product.
- **"Other relevant information"** - setting out a brief indication of any additional information documents to be provided to the investor by the product manufacturer at pre and/or post contractual stage, excluding any marketing material.

Regulatory technical standards are expected to be developed specifying the details of the presentation and content of each of the elements, the methodology underpinning the presentation of risk and reward and the methodology for calculation of costs including the specification of summary indicators.

Onus on PRIIPs manufacturers

It is an obligation on the PRIIP manufacturer to draw up the key information document and to publish the document on its website, which must be done before a PRIIP is made available to retail investors. The PRIIP manufacturer must also review the information contained in the document regularly and revise it when the review indicates that changes need to be made.

Note the finalised terms of Article 11 of the Regulation. Where a retail investor demonstrates a loss resulting from the reliance on a key information document when making an investment into the product for which the document was produced, that retail investor may claim damages from the PRIIP manufacturer for that loss in accordance with national law. But this provision refers to the circumstances set out in paragraph 1 of Article 11. Paragraph 1 provides that the PRIIP manufacturer shall not incur civil liability solely on the basis of the key information document, including any translation thereof, unless it is misleading or inaccurate or is inconsistent with the relevant parts of legally binding pre-contractual and contractual documents or with the requirements set out in Article 8 for the contents of the document.

Obligations to provide the KID

The obligation to provide it is imposed upon the person advising on or selling the PRIIP. The phrase "person selling a PRIIP" is defined to mean a person offering or concluding the PRIIP contract with a retail investor.

Under Section III of the Regulation, as with UCITS KID documents at present, the PRIIPs KID will have to be provided to retail investors in good time before he is bound by any contract or offer relating to the PRIIP. It is not sufficient that it is simply offered.

This requirement may be satisfied if providing the KID to a person with written authority to make investment decisions on behalf of the retail investor in respect of transactions concluded under that authority.

By way of exception, a person selling a PRIIP may provide the retail investor with the KID without undue delay after the conclusion of the transaction where all of the following conditions are met:

- the retail investor chooses on his own initiative to contact the seller of the product and conclude the transaction using a means of distance communication;
- the provision of the key information document before he is bound by the contract or offer is not possible;
- the person advising or selling the PRIIP has informed the retail investor of this fact and clearly stated that the retail investor may delay the transaction in order to receive and read the key information document before concluding the transactions; and

- the retail investor consents to receiving the KID without undue delay after the conclusion of the transaction, rather than delaying the transaction in order to receive the document in advance.

There is also an exception for successive transactions regarding the same product which are carried out on behalf of the retail investor in accordance with instructions given by that investor to the person selling the product prior to the first transaction, where the obligation to provide the KID shall only apply to the first transaction and to the first transaction after the key information document has been revised in accordance with Article 10.

Method of delivery

The person advising on or selling a PRIIP shall provide the key information document to retail investors free of charge. It must be provided in one of the following media:

- on paper, which should be the default option in case the PRIIP is offered on a face to face basis, unless the retail investor requests otherwise;
- using a durable medium other than paper. This is permitted where the use of durable medium is appropriate in the context of the business conducted by the person advising on or selling a PRIIP and the retail investor; and the retail investor has been given the choice between information on paper and in durable medium and has chosen that other medium in a way that it can be evidenced; or
- by means of a website. It is possible to provide it by means of a website that does not meet the definition of a durable medium if all of the following conditions are met:
 - the provision of the KID by means of a website is appropriate in the context of the business conducted by the person advising on or selling the product and the retail investor;
 - the retail investor has been given the choice between information on paper and the means of a website and has chosen this medium in a way that can be evidenced;
 - the retail investor has been notified electronically, or in written form, of the address of the website, and the place on the website where the key information document can be accessed;
 - where the KID has been revised, previous versions shall also be provided on request of the retail investor; and
 - it is ensured that the KID remains accessible on the website, capable of being downloaded and stored in a durable medium, for such period of time as the retail investor may need to consult it.

Retail investors must therefore be given the KID on paper unless they have chosen a medium other than paper.

Intervention powers

EIOPA's and relevant national regulators' powers are complemented with an explicit mechanism for prohibiting or restricting the marketing, distribution and sale of insurance-based investment products giving rise to serious concerns regarding investor protection, orderly functioning and integrity of financial markets, or the stability of the whole or part of the financial system, together with appropriate coordination and contingency powers of EIOPA. This is to reflect also the powers provided to ESMA and EBA under MiFIR so as to ensure such mechanisms for intervention can be applied to all investment products irrespective of their legal form.

During the course of the drafting of the Regulation a new Chapter IIa was introduced which deals with product intervention powers.

Penalties and other measures

Chapter IV of the Regulation provides that, without prejudice to supervisory powers of competent authorities and the rights of member state to provide for and impose criminal sanctions, Member States must lay down rules establishing appropriate administrative sanctions and measures applicable to situations which constitute a breach of the Regulation.

The administrative measures and sanctions must at least encompass an order prohibiting the marketing of a PRIIP; an order to suspend the marketing for a PRIIP; a public warning which indicates the person responsible and the nature of the breach; an order prohibiting the provisions of a KID which does not comply with the relevant requirements and requiring publication of a new version; and administrative pecuniary sanctions.

The finalised level of those pecuniary sanctions is at least:

- in the case of a legal entity,
 - up to €5 million or up to 3% of the total annual turnover according to the last available accounts approved by the management body. Where the legal entity is a parent undertaking or a subsidiary of a parent undertaking which has to prepare consolidated financial accounts, the relevant total turnover shall be the total annual turnover or the corresponding type of income according to the relevant accounting Directives according to the last available consolidated account approved by the management body of the ultimate parent undertaking; or
 - up to twice the amount of profits gained or losses avoided because of the breach where those can be determined, or
- in the case of a natural person;
 - up to €700,000 or the corresponding value in national currency; or

- up to twice the amount of the profits gained or losses avoided because of the breach where those can be determined.

This is without prejudice to the possibility for Member States to provide for additional sanctions and measures and for higher levels of administrative pecuniary sanctions.

Timetable and transitionals

The Regulation will enter into force on the 20th day following its publication in the Official Journal and shall apply from two years after the date of entry into force of the Regulation. It is therefore likely that it will take effect during 2016.

For UCITS which are already producing KIDs there is an exemption for a period until the date which is five years after the entry into force of the Regulation.

There is to be a market survey and general review of the Regulation four years after its date of entry into force and, at that point, the review shall assess whether the transitional arrangements for UCITS should be prolonged or whether the provisions on key investment information in the UCITS Directive might be replaced by, or considered equivalent to, the PRIIPs key information documents.

At that point there is an intention also to reflect upon the possible extension of the scope of the Regulation to other financial products and to reassess whether the exemption of products from scope of the Regulation. The review should also assess the appropriateness of introducing common rules on the need for all member states to provide for administrative sanctions for breaches of the Regulation.

Will this measure work?

In the UK we are well used to the notion that the provision of appropriate information at point of sale is important in providing one element of investor protection so that investors can decide to buy products on an informed basis. The UK has long experience of such documents across a wide range of investment and insurance products having first tried to introduce key features documents for both investment funds and insurance products in the early 1990s. However, it is inevitably only one element of the protection retail investors need. And it is very difficult to know quite how to formulate and present the information.

From the EU perspective, given the failure of the simplified prospectus for UCITS funds and the fact that the UCITS KID documents are still relatively new, it may be too early to say whether this new initiative will be successful.

It is helpful that the European Commission appreciate that they will need to keep the performance of the key information documents under review. This shows a willingness to look at results at an early stage to see if adjustments may need to be made for example to some of the key indicators.

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