

23 January 2014

## PRIPs Trilogue issues

### Executive Summary

- **The Joint Associations Committee on Retail Structured Products (the JAC<sup>1</sup>) welcomes the proposed introduction of a requirement for manufacturers of certain types of investment products to provide prospective retail investors with a key information document (KID) summarising the most important features of those products. A standardised and concise disclosure document is likely to assist retail investors in understanding the key features of different types of products and in identifying the key differences between them.**
- **The JAC supports the approach taken by both the Commission and the Council in setting out a relatively high-level summary of the content requirements of a KID, with further detail on the precise content and style requirements to be set out in Level 2 legislation. The JAC supports the Commission's approach of not specifying a maximum page limit in the Level 1 Regulation.**
- **The JAC is strongly of the view that a KID alone cannot provide the basis of an informed investment decision. To suggest that a fully informed decision could be made on the basis of reading a KID alone is misleading and ultimately detrimental to investors. It may also discourage investors from taking appropriate advice on the product documentation and is inconsistent with the recently updated Prospectus Directive regime. Accordingly the JAC supports the general approach taken by the Council (as expressed in Article 8 (2) and Article 11) as to the purpose of the KID but also proposes that Recitals 10, 11, 16 and 19 be amended so as to remove the implication that a KID alone will enable retail investors to take an informed investment decision.**
- **The JAC is strongly of the view that, following the approach taken for the Prospectus Directive (Article 6(2)) and UCITS (Article 79(2) of the UCITS Directive), the PRIPs Regulation should not seek to set out detailed provisions as to the specific remedies which may be available in any proceedings arising in connection with a KID. Such remedies are already well established and efficiently achieved under national law. An additional and entirely separate liability regime under the PRIPs Regulation would give rise to legal uncertainty and inconsistency with national regimes with the consequent detriment to both retail investors and product manufacturers. Accordingly the JAC supports the Council's general approach insofar as it relates to liability for misleading or inaccurate disclosure in a KID but proposes certain changes to the text of Article 11 of the Council's general approach**

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<sup>1</sup> The members of the JAC comprise a large proportion of the major firms involved in the creation, manufacturing and distribution within the European Union of retail structured products and furthermore is sponsored by multiple associations with an interest in retail products.

to align it more closely with the Prospectus Directive.

- **The precise territorial scope of the PRIPs Regulation should be clarified in the text of the final PRIPs Regulation. In order to best give effect to the policy objectives of the Regulation (namely protecting, informing and educating retail investors in EEA Member States), the JAC believes that the Regulation should be limited to investment products sold to retail investors located in EEA Member States, but that it should apply to all product manufacturers and distributors regardless of where they are located.**
- **The JAC supports the approach taken by each of the Commission and the Council in focusing the PRIPs Regulation exclusively on the disclosure to be provided to prospective retail investors. Whilst the JAC welcomes an informed debate on product intervention and governance, it believes that the PRIPs Regulation is not the appropriate forum for this.**
- **The JAC submits that a numerical risk reward indicator should not be included as one of the content requirements on the basis that it is likely to mislead investors and discourage them from fully reading and understanding the risk profile of the product.**

## **1. ARTICLES 5 AND 6 - CONTENT AND LENGTH OF A KID**

### **1.1. General content requirements of a KID**

Each of the drafts of the PRIPs Regulation prepared by the Commission, the Council and the European Parliament provides an outline of the content requirements for a KID, although the European Parliament's draft Regulation goes into significantly more detail than the other drafts.

### **1.2. JAC's Comments and Justification**

The JAC considers that in order to reflect accurately the key considerations for a prospective retail investor, a significant degree of industry and product-specific consultation and analysis will be necessary. The JAC therefore supports the approach taken by the Commission and the Council that further detail on the content and style requirements should be provided at Level 2.

In particular, the European Parliament's proposals relating to (i) the inclusion of a complexity label, (ii) the creation of an online fund calculator (which would, it seems, sit alongside the disclosure in a KID) and (iii) product distributors annexing additional information to a pre-existing KID each require further consultation and consideration at Level 2 in order to avoid considerable uncertainty and potential risk for market participants.

More generally, a detailed Level 2 process, as suggested by the Commission and the Council, will help to ensure that the final content requirements of a KID:

- (i) are expressed in objective terms, so as to allow product manufacturers and retail investors to be certain as to what they can expect to be included in a KID; and
- (ii) be limited to information that is within the knowledge and control of the product manufacturer (at least to the extent that the product manufacturer is to be held responsible for such information).

### 1.3. Page length of a KID

In light of the suggestions set out above in relation to the content of a KID (and the suggestions set out in Paragraph 2.4 below), the JAC supports the Commission's approach of not specifying a maximum page limit in the Level 1 Regulation. This is in contrast to the proposals put forward by both the Council and the European Parliament.

As the precise form and content of a KID are likely to be subject to further consultation and specification in Level 2 legislation, and any page length requirements will need to take into account the specific content requirements, the JAC supports the page length specifications also being set out in Level 2 legislation.

## 2. ARTICLES 8 AND 11 - PURPOSE OF THE KID

Set out below is an overview of the respective approaches taken by the Commission, the Council and the European Parliament on the purpose of the KID.

### 2.1. Commission

In its Explanatory Memorandum, the Commission indicates that "investors should not be required to read other documents to be able to understand the key features of the investment product and take an informed investment decision ...".

Similarly, the Commission's proposed mandatory form of explanatory statement to be included in each KID (as set out in Article 8(1) of the Commission's text) states (emphasis added):

"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 of this investment product and the risks of investing in it. *You are advised to read it so that you can take an informed decision about whether to invest.*"

Article 11 of the Commission's proposed Regulation (when read together with Article 6(1)) further provides that a product manufacturer may be liable (provided that certain other requirements are satisfied) if it prepares a KID which is not "accurate, fair, clear and not misleading", when considered on a standalone basis. It seems that standalone liability could also attach to a KID if it contains insufficient information to enable an investor to make an informed investment decision, although this is not entirely clear from the drafting.

### 2.2. Council

In contrast to the approach adopted by the Commission, the Council's draft Regulation makes it clear that a KID should not be the only document which investors should read in order to make an informed investment decision. The Council's proposed mandatory form of explanatory statement to be included in each KID (as set out in Article 8(1) of the Council's text) states (emphasis added):

"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 and rewards of this investment product and to help you to compare it against other investment products.*

This pre-contractual document, *along with other relevant pre-contractual and contractual documents which you should also read*, does not establish whether the product is suitable for you.”

The Council’s approach to product manufacturer liability is consistent with its position that a KID should be read alongside other documents. In particular, Article 11 of the Council’s draft Regulation provides as follows (emphasis added):

“1. The information in the key information document shall constitute pre-contractual information. It shall be accurate, fair, clear and not misleading. *Where binding contractual documents exist, the key information document shall be consistent with those documents.*

2. *A PRIIP manufacturer shall not incur civil liability solely on the basis of the key information document, including any translation thereof, unless it is inconsistent with pre-contractual or contractual documents* under the product manufacturers control, or is misleading or inaccurate. The key information document shall contain a clear warning in this regard.”

### **2.3. European Parliament**

The European Parliament’s draft Regulation does not expressly identify whether or not a KID should be capable of forming the basis of an informed investment decision. However, it does imply that the function of the KID is to enable retail investors make such a decision.

Article 11(1) includes the following:

“Where an investment product manufacturer has produced a key information document which does not comply with the requirements of this Regulation and on which a retail investor has relied when making an investment decision...”

Like the Commission (but unlike the Council), the European Parliament proposes that standalone liability should attach to a KID, rather than liability only potentially arising if the KID is inconsistent, misleading or inaccurate.

### **2.4. JAC’s Comments and Justification**

The JAC supports the Council’s proposed form of mandatory statement in Article 8(1) (but does not support the Commission’s or the European Parliament’s proposal).

However, the JAC also believes that some of the recitals in the drafts of the PRIPS Regulation prepared by each of the Commission, the Council and the European Parliament need to be amended to conform them with the purpose of a KID (as expressed in Article 8(1) of the Council’s text) and avoid the creation of false expectations for the reader of the KID.

*Recital 10:*

Delete final sentence (“Furthermore, retail investors should be able to understand the key information document on its own without referring to other information”).

*Recital 11:*

“Retail investors should be provided with the information to help them understand the nature, risks and rewards of an investment product and to help them to compare it against other investment products necessary for them to take an informed investment decision...”

*Recital 16:*

“Key information documents are the foundation for investment decisions by retail investors important, together with other documentation for the investment product being considered, to help retail investors to take better investment decisions...”

*Recital 19:*

“So that the retail investor is able to take an informed investment decision make use of a key information document...”[the KID should be provided to investors in good time]

The justification for the JAC’s position is as follows:

The recitals referred to above (in their unamended state), and the Commission’s text of Article 8(1), imply that retail investors can rely on the KID to make an informed investment decision. The JAC strongly disagrees with this proposition. Given the physical constraints on the length of the KID, it cannot perform that role in the context of, for example, a structured bond. Only a prospectus can do that and the information that is prescribed by EU legislation to achieve that purpose is much more extensive than that which could be included in a KID. To suggest that a fully informed decision could be made on the basis of reading a KID alone is misleading and ultimately detrimental to investors

In the EU, the standard of disclosure required in a prospectus for transferable securities is set out in the prospectus directive (2003/71/EC) (the “**Prospectus Directive**”) and the Prospectus Regulation (809/2004) (the “**Prospectus Regulation**”). Article 5 of the Prospectus Directive provides that the prospectus must contain all information as is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer, and of the rights attaching to the securities being issued or offered.

Further specific and detailed disclosure requirements are then set out in the Prospectus Regulation, which specifies the “minimum” disclosure that is required to enable the investor to take informed investment decisions. Different lists apply in different circumstances; but, for example, the list of the headings of the disclosure items that apply to derivative securities (Annex XII) runs to 4 sides of A4.

Therefore, if the purpose of the disclosure is to enable investors to take an informed investment decision, the amount of information that is prescribed by EU legislation to achieve that purpose is much more extensive than that which could be included in a KID.

Furthermore, were a KID to provide that level of detailed information on a standalone basis there is a danger that investors would not read other relevant product documentation and may not take appropriate advice. This would not be in the interests of consumers or the market. Significant consumer protection provisions are being incorporated into the MiFID II regime and the IMD II, and the PRIIPs Regulation should focus on ensuring that a KID provides a high standard of summary disclosure and does not discourage investors from reading other product literature which retail investors already find useful.

### 3. ARTICLE 11 - LIABILITY ARISING IN CONNECTION WITH A KID

Set out below is an overview of approaches taken by the Commission, the European Parliament and the Council on liability arising in connection with a KID.

#### 3.1. Commission

Article 11(1) in the Commission's proposed Regulation provides as follows (emphasis added):

“Where an investment product manufacturer has produced a key information document which does not comply with the requirements of Articles 6, 7 and 8 on which a retail investor has relied when making an investment decision, *such a retail investor may claim from the investment product manufacturer damages for any loss caused to that retail investor through the use of the key information document.*”

The Commission's proposed Regulation also reverses the burden of proof with respect to liability arising from a KID: if a retail investor suffers a loss resulting from the use of the information in a KID, the product manufacturer will be liable unless they can prove that the KID complies with Articles 6, 7 and 8 of the Regulation (Article 11(2)).

#### 3.2. European Parliament

Article 11(1) in the draft Regulation prepared by the European Parliament is broadly similar to the equivalent provision in the Commission's proposed Regulation, but also includes an express right for a retail investor to return the investment product if the relevant KID does not comply with the Regulation. Article 11(1) provides as follows (emphasis added):

“Where an investment product manufacturer has produced a key information document which does not comply with the requirements of this Regulation and on which a retail investor has relied when making an investment decision, such a retail investor may claim from the investment product manufacturer damages for any loss caused to that retail investor through the use of the key information document *and may, where appropriate, return the investment product and have losses refunded.*”

Like the Commission's draft Regulation, the European Parliament's draft also contemplates a reversal of the burden of proof in favour of the retail investor.

#### 3.3. Council

In contrast to the approach adopted by the Commission and the European Parliament, the Council's proposal does not expressly provide for (i) a right to damages or a right to return the product or (ii) a reversal of the burden of proof. Article 11 of the Council's draft Regulation provides as follows:

“1. The information in the key information document shall constitute pre-contractual information. It shall be accurate, fair, clear and not misleading. Where binding contractual documents exist, the key information document shall be consistent with those documents.

2. A PRIIP manufacturer shall not incur civil liability solely on the basis of the key information document, including any translation thereof, unless it is inconsistent with pre-contractual or contractual documents under the product manufacturers control, or is

misleading or inaccurate. The key information document shall contain a clear warning in this regard.”

### **3.4. JAC’s Comments and Justification**

The JAC supports the Council’s text for Article 11, with the following changes:

“1. The information in the key information document shall constitute pre-contractual information. It shall be accurate, fair, clear and not misleading. Where binding contractual documents exist, the key information document shall be consistent with those documents.

2. A PRIIP manufacturer shall not incur civil liability solely on the basis of the key information document, including any translation thereof, unless it is misleading, inaccurate or inconsistent, when read together with other pre-contractual or contractual documents under the product manufacturer’s control, ~~or is misleading or inaccurate~~. The key information document shall contain a clear warning ~~in this regard~~ to that effect.”

The justification for the JAC’s position is as follows:

(a) The KID should always be an aid that has to be read together with other documentation or in conjunction with professional advice. It can never provide sufficient information for an investment decision on its own. The unamended text of Article 11 would mean that whether a KID is inconsistent would have to be judged by reference to other contractual documents; but contractual or pre-contractual documents would be ignored if the allegation was that it was misleading or inaccurate.

(b) The PRIPs Regulation should not seek to set out detailed provisions as to the specific remedies which may be available in any proceedings arising in connection with a KID. These remedies are already well established and efficiently achieved under national law. An additional and entirely separate liability regime under the PRIPs Regulation would give rise to legal uncertainty and inconsistency with national regimes with the consequent detriment to both consumers and providers.

(c) The Council’s general approach is also more closely aligned with the approach taken by existing legislation in this area - namely the liability regime for a summary included in a prospectus set out in Article 6(2) of the Prospectus Directive and Article 79(1) of the UCITS Directive which sets out the purpose of the KID in the UCITS context. These directives are recent and there has been no adequate evidence to demonstrate that either directive is defective in this context. Fundamental changes to EU legislation should only be made following evidence based justification.

### **3.5. Territorial scope of potential liability**

The various drafts of the PRIPs Regulation refer generally to “retail investors”, the definition of which is linked to MiFID and IMD. However, the precise territorial scope of the PRIPs Regulation is not entirely clear. In order to best give effect to the policy objectives of the PRIPs Regulation (namely protecting, informing and educating retail investors in EEA Member States), the JAC proposes that:

(i) the territorial scope of the PRIPs Regulation should be limited to investment products sold to retail investors located in EEA Member States; and

- (ii) the Regulation should apply to all product manufacturers and distributors regardless of whether they are located inside or outside the EEA. Any PRIPs sold in the EEA needs to be accompanied by a KID.

This position should be clarified in the text of the final Regulation.

#### **4. ARTICLE 13 - PRODUCT INTERVENTION**

Set out below is an overview of approaches taken by the European Parliament, the Council and the Commission on product intervention.

##### **4.1. European Parliament**

Recital 21a of the European Parliament’s draft Regulation provides as follows:

“Although improving investment product disclosures is essential to rebuilding the trust of retail investors in the financial markets, product design rules are equally important to ensure effective retail investor protection. Imperfect advice from financial advisors, bias in decision-making and evidence that financial behaviour depends primarily on psychological attributes give rise to issues that need to be addressed through curbing complexity in the packaging of investment products.”

In addition, Articles 5a, 8a, 13a, 13b, 13c, 13e and 13f of the European Parliament’s draft Regulation contain detailed rules relating to product intervention and product governance.

##### **4.2. Council**

In contrast to the approach taken by the European Parliament, the Council clarifies in Recital 4 of its draft of the Regulation that:

“This regulation has no effect on the supervision of advertising documents nor on product intervention measures.”

##### **4.3. Commission**

The Commission’s draft Regulation does not contain any references to product intervention or product governance, focusing instead on disclosure to prospective retail investors (and on remedies for any misleading or inaccurate disclosure in a KID).

##### **4.4. JAC’s Comments and Justification**

Like the regime for a prospectus summary under the Prospectus Directive, the core objective of the PRIPs regime is to provide investors with a concise document which focuses on the key information that investors need in order to be able to decide which products to consider further. With this in mind, the JAC supports the approach taken by each of the Commission and the Council in focusing the PRIPs Regulation exclusively on the disclosure requirements which product manufacturers will need to comply with.

Whilst the JAC welcomes an informed debate on product intervention and governance, it believes that the PRIPs Regulation is not the appropriate forum for this. Detailed product intervention measures are already being considered in the context of the MiFID II regime (see, in particular, Articles 1(e), 31, 32 and 33 of the most recent Council and Parliament drafts of

MiFIR) and including similar requirements in the PRIPs Regulation could create unnecessary duplication and/or uncertainty. If the reason why the European Parliament's text of the PRIPs Regulation includes product intervention measures is because of the limited product scope of MiFID (and, in particular, the product intervention powers in MiFID not extending to insurance based investment products) we would suggest that a better solution would be to address this through IMD II (rather than through the PRIPs Regulation).

## **5. SUMMARY RISK REWARD INDICATOR (SRRI)**

The JAC has strong reservations regarding the inclusion of a summary risk reward indicator as it believes that this may not improve investor understanding of the risks involved in the relevant product and could even be misleading. In particular:

- (i) the Commission's own consumer research suggests that investors place too much reliance on risk indicators and do not pay sufficient attention to warnings setting out the limitations and assumptions that apply to the indicator. This leads to investors reaching distorted conclusions as to the risks of a particular product. This is a particular concern in the context of non-UCITS PRIPs, for which the risk profile is generally more diverse than that involved in a UCITS (in particular, given the additional obligor credit risk dimension). A single figure SRRI may discourage investors from fully reading and understanding the risk profile of the relevant product;
- (ii) PRIPs have diverse risk profiles and risk is often investor specific. For example, an investor investing in a product denominated in a currency other than that of his or her home Member State takes significant foreign exchange risk, which may not be factored into the indicator. Consequently, narrative risk explanations are far more useful to investors, as they enable them to assess the relevance of each risk factor identified in the context of their specific portfolio;
- (iii) finding a common SRRI calculation methodology that could be used across the full range of PRIPs would represent a significant, if not impossible, challenge. The nature of many PRIPs is fundamentally different from UCITS. As such the regime applying to UCITS cannot easily be applied to other PRIPs products in a way that would allow for reliable or meaningful ratings to be produced. In addition, were different methodologies to be applied to different product categories, there is a significant risk that investors would nonetheless regard the index scores as comparable across product categories;
- (iv) computing a calculation basis for a risk indicator for products for which there is no (or limited) past performance data presents significant challenges and where past performance data does exist, that data is, by definition, historic and may not be an accurate prediction of future performance. Furthermore, any element of subjectivity introduced into the calculation methodologies for such products (as may be unavoidable) would open the party calculating the rating to liability risk in respect of investors subsequently seeking to challenge an assumption made in the course of such calculation;
- (v) if a risk indicator is included, an explanation of the indicator, the score and warnings in relation to its reliability must also be included and this would use up space in the document which could otherwise have contained more meaningful disclosure of the

actual risks involved in the product, and would add unnecessary clutter to the document (when space is already at a premium); and

- (vi) there are concerns that, capital protected products which are highly complex but relatively low risk (e.g. complex structuring might be used to reduce risk), may, if the indicator is not designed appropriately, be incorrectly represented as higher risk due to their complexity.