

# Structured Thoughts

*News for the financial services community.*



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## **EU Commission's Further Consultation on PRIPs**

As part of the long, ongoing process of seeking to promote a more consistent approach in the regulation of structured retail financial products, on 26 November 2010, the EU Commission published its consultation paper (the "Consultation Paper") on legislative steps for packaged retail investment products ("PRIPs").<sup>1</sup>

It had originally been expected that the Commission would publish more detailed legislative proposals rather than a further consultation paper. The Consultation Paper does, however, build upon the earlier Commission communication in relation to PRIPs dated 30 April 2009,<sup>2</sup> and a subsequent update and technical workshops. It also takes into account the recent joint report of the three Level 3 Committees (the "3L3 Report").<sup>3</sup> As with the previous consultations and reports, the Consultation Paper focuses on three key areas: (i) the scope of the definition of PRIPs, (ii) a more consistent approach to pre-contractual disclosure across different products, and (iii) the rules in relation to selling practices.

<sup>1</sup> Working Document of the Commission Services (DG Internal Market): Consultation by Commission Services on legislative steps for the Packaged Retail Investment Products initiative (26 November 2010), [http://ec.europa.eu/internal\\_market/consultations/docs/2010/priips/consultation\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2010/priips/consultation_paper_en.pdf).

<sup>2</sup> European Commission Communication on Packaged Retail Investment Products (30 April 2009), [http://ec.europa.eu/internal\\_market/finservices-retail/docs/investment\\_products/29042009\\_communication\\_en.pdf](http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/29042009_communication_en.pdf).

<sup>3</sup> Report of the 3L3 Task Force on PRIPs (6 October 2010), <http://www.cesr.eu/popup2.php?id=7278>.

## Scope of the PRIPs Regime

The Commission states that it believes a key characteristic of PRIPs is that they are “manufactured” by a firm which packages different assets or elements of an investment together, either by wrapping a financial asset within another structure (such as a UCITS fund or structured note), by providing investment management through a collective investment scheme or by devising a financial instrument that creates exposure to other instruments, indices or reference values.

The Commission acknowledges that establishing a clear definition of such products is challenging, but considers the objectives of the definition should be to:

- encompass all the key packaged investment products being marketed domestically and cross-border within the EU at present;
- be flexible enough to cover new products as they develop;
- avoid incentivising regulatory arbitrage; and
- provide sufficient legal certainty as to which products are covered by the definition.

Having regard to these considerations, the Commission concludes that the definition should be focused on packaged products rather than seeking to encompass most investment products sold to retail investors. The following definition is proposed:

*“A PRIP is a product where the amount payable to the investor is exposed to fluctuations in the market value of assets or payouts from assets, through a combination or wrapping of those assets, or other mechanisms than a direct holding.”*

This definition is intended to be sufficiently broad to include all investment funds and all structured products (whether packaged as insurance policies, funds, securities or deposits). It should not, however, catch most vanilla bonds and simple deposits. Pure protection products will also be excluded. The Commission, however, envisages that the proposed definition will catch many derivative instruments. This is likely to be the subject of some discussion during the consultation process as bilateral derivatives are not generally regarded as packaged instruments. This may, however, not be a major issue in practice as it is not clear that retail investors commonly enter into derivative contracts.

One of the issues debated during the consultation process to date has been whether the definition for PRIPs should make it clear that the regime only applies to products intended for retail investors. The concern is that otherwise retail-type disclosure and selling rules could be imposed on products principally intended for wholesale investors. In accordance with the recommendations in the 3L3 Report, the Commission concludes that the retail element should not be included within the PRIPs definition but instead the relevant PRIPs pre-contractual disclosure and selling rules should only apply to a product that is being sold to a retail investor.

The Commission acknowledges that, whilst the definition focuses on packaged products, it may still cover some financial products not intended to fall within the ambit of the initiative and further clarity may be needed in certain areas, including the following:

(a) **Deposits:** Whilst simple deposits are not intended to be included within the proposed definition, the Commission believes structured deposits should be included, given their complexity and similarity to other structured products. It has suggested two approaches for determining what constitutes a structured deposit for this purpose: either (i) a fully-repayable deposit whose payment terms in relation to interest or premium are based on a formula involving the performance of an index or combination of indices (but not including deposits linked to an interest rate index such as EURIBOR or LIBOR), a financial instrument within the meaning of the Markets in Financial Instruments Directive

("MiFID"),<sup>4</sup> a commodity or foreign exchange rate, or (ii) any deposit where principal is not repayable at par or is only repayable at par under a particular guarantee or agreement provided by the credit institution or a third party. The second approach is intended to tie in with the Commission's work on deposit guarantee schemes and has the benefit of simplicity but is likely to exclude deposits where the principal is repayable at par but interest is, for example, index-linked. This would be comparable as a product to a fully principal protected index-linked structured note, which looks certain to be included within the PRIPs definition.

(b) **Pensions:** The Commission notes that this is a difficult area due to the heterogeneous nature of the pensions market across the EU and the difficulty of identifying which pensions should fall under the scope of the PRIPs regime. The Commission has therefore indicated it is likely to exclude pensions from the scope of PRIPs at present, with the possible exception of investments packaged as variable annuities which it considers to be a grey area. It has asked for further input as to whether it is appropriate to include such products within the PRIPs regime.

The Commission states that the definition of PRIPs would need to be clarified through further work at a secondary level and believes this could take the form of an indicative list of PRIPs setting out products which either do or do not fall within the regime. Such a list could also be supplemented by technical standards or guidance and is likely to be updated periodically to adapt to product innovation.

### Pre-Contractual Disclosures

The Commission noted that the regulatory landscape in relation to contractual disclosure is particularly fragmented with different regimes under the UCITS Directive, the Prospectus Directive and the Solvency II Directive applying to different products and structured deposits not being covered by any regime.

Consistent with the previous consultation documents, it is proposed that a new key investor information document ("KIID") be developed for PRIPs, which would apply the same broad principles as developed for the KIID under the UCITS regime.

Although the Commission has previously acknowledged in the consultation process that some PRIPs are very different from an investment in a UCITS fund, it believes that the broad principles underlying the approach in connection with the UCITS KIID are a good guide to the approach that should be taken to developing the PRIPs KIID. These include:

- addressing retail investors' needs for pre-contractual information so as to improve decision making;
- providing sufficient information to enable the average retail investor to make an informed decision without reference to other material; and
- focusing the document to communicate key points to retail investors.

The Commission indicates that it is likely that the PRIPs KIID will, as with the UCITS KIID, be required to be a document separate from any other prospectus or background document, although it has asked for further views on this point.

One concern raised by various market participants in the consultation process to date is that the regime for the UCITS KIID is very prescriptive with the aim of ensuring a high degree of standardisation. The Commission acknowledges that in view of the wide variety of product features between different types of PRIPs, a "one size fits all" approach is not appropriate. It believes, however, that overarching principles should be developed which would apply to all PRIPs. Detailed requirements would then be tailored through implementing measures for different types of PRIPs. The Commission believes that in relation to certain information such as costs, performance, risks and

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<sup>4</sup> Markets in Financial Instruments Directive (2004/39/EC), [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l\\_145/l\\_14520040430en00010044.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l_145/l_14520040430en00010044.pdf).

guarantees a common approach will be needed across all PRIPs, but has not yet suggested what that approach might be.

The Commission repeats and seeks views of market participants on its proposals on the broad content and format of the disclosure set out in its December 2009 update on PRIPs<sup>5</sup> which included requirements that the KIID be fair, clear and not misleading, be no more than two pages in most cases, be written in plain language suited to retail investors and be presented in an appealing and consumer-friendly manner. It also envisaged that the document would contain information on the broad risk / reward proposition represented by the product and product costs. Issues highlighted by the Commission, as requiring particular consideration in developing the PRIPs KIID so as to aid investors in making a comparison between different types of product, include the following:

(a) **Risks:** The UCITS KIID requires a simple risk indicator which presents disclosures of investment risk graphically on a scale of 1 to 7 using historical volatility data. The Commission believes that this broad approach could be adapted for many PRIPs, such as unit-linked insurance contracts. It notes that there are challenges in applying such an approach to all PRIPs generally and that a recalibration of the rating scale may be necessary to reflect the different product types. It also notes that certain risks, such as counterparty and liquidity risks, are relatively controlled for UCITS but may be more of an issue for other products. Concerns have, however, been raised by a number of market participants that providing a risk indicator rating for PRIPs is likely to give an oversimplified measure of risk.

(b) **Costs:** The Commission believes a key aim of the PRIPs KIID should be to provide information to enable retail investors to compare the costs of different products. For fund-based PRIPs which typically have limited one-off exit and ongoing management fees, it believes a simple presentation of such information can aid comparison between funds. For other PRIPs, it acknowledges the cost structure may be more complex and vary between different investors. It therefore believes further work is necessary to identify the key information about costs that should be provided for such products.

(c) **Performance:** It is acknowledged that information about performance can take a variety of forms and can be either backward- or forward-looking. The Commission believes that further work is needed to identify possible common approaches to performance in a manner that can be understood by retail investors and facilitate comparison between different products.

(d) **Guarantees:** The Commission states that information to enable comparability between guarantees or capital protection for PRIPs is critical but it is challenging to do this effectively in a “key messages” document. It believes further work is necessary in this area to facilitate an informative comparison between different products.

Consistent with the conclusions set out in the 3L3 Report, the Commission favours the product manufacturer being responsible for the preparation of information in the KIID, although it leaves open the possibility of an intermediary that seeks to sell a PRIP to a retail client, assuming responsibility for the preparation of the KIID in certain circumstances.

The Commission notes that there are already a number of disclosure requirements in relation to many PRIPs. It intends to seek to avoid duplication where possible and indicates this might involve amending the Prospectus Directive, so that for PRIPs subject thereto a KIID would satisfy the requirement for a prospectus summary, and amending Solvency II, so that for PRIPs subject to Solvency II a KIID would satisfy any duplicate disclosure requirements. It notes it will also be necessary to clarify the interaction of the PRIPs KIID regime with the UCITS KIID regime but for the time being it does not intend that the PRIPs KIID regime would not override the UCITS KIID regime for UCITS.

<sup>5</sup> Update on Commission work on Packaged Retail Investment Products (PRIPs) (December 2009), [http://ec.europa.eu/internal\\_market/finances-retail/docs/investment\\_products/20091215\\_prips\\_en.pdf](http://ec.europa.eu/internal_market/finances-retail/docs/investment_products/20091215_prips_en.pdf). See also Morrison & Foerster client alert: An update on the EU actions on PRIPs (10 February 2010), [http://www.mofo.com/files/Publication/f17b0cf1-4d0f-469a-955d-e48fe44565bd/Presentation/PublicationAttachment/a7aa0212-967d-4490-940d-ff237efc43b8/100210Structured\\_thoughts\\_issue\\_3.pdf](http://www.mofo.com/files/Publication/f17b0cf1-4d0f-469a-955d-e48fe44565bd/Presentation/PublicationAttachment/a7aa0212-967d-4490-940d-ff237efc43b8/100210Structured_thoughts_issue_3.pdf).

Whilst the Commission recognises that there will need to be flexibility in the pre-contractual disclosure regime to reflect the different features between many PRIPs, there is likely to be continuing market concern that the format and content rules for the KIID are not overly prescriptive and are not overly reliant on the framework for the UCITS KIID. Responses to the previous consultations, including from the Joint Associations Committee on Retail Structured Products (“JAC”), have highlighted the fact that PRIPs structured as a fund (such as a UCITS) are very different in nature from PRIPs structured on a contractual framework such as a structured note or deposit, which will necessitate some differences in the relevant KIID. The JAC previously prepared a draft template KIID for consideration by the Commission. Although the Consultation Paper addresses some of the issues to be considered in this regard, including risks, costs and past and future performance, it sets out little in the way of specific proposals. In the context of pre-contractual disclosure, it is also interesting that the Commission envisages that the KIID be kept up to date and accurate. It is not clear if this is intended to apply to all PRIPs, including those issued on a stand-alone basis with no provision for continuous issuance, whether a KIID will be necessary in relation to secondary sales of the PRIP and who would be responsible for maintaining the KIID.

### Selling Rules

In relation to the selling requirements, most PRIPs are governed by either MiFID, which applies to PRIPs that are financial instruments, or the Insurance Mediation Directive (“IMD”),<sup>6</sup> which applies to PRIPs that are insurance products. A small number of products, including structured deposits, are not covered by either regime.

Rather than developing a new sales regime, the Commission favours aligning the existing MiFID and IMD regimes to apply to all PRIPs. It proposes extending the MiFID sales rules to all PRIPs (other than insurance PRIPs) that are not currently covered. These rules would apply even where an exemption may otherwise apply under the existing MiFID rules. In relation to insurance products, it is proposed that the IMD be amended to introduce rules consistent with those in MiFID in relation to conflicts of interest and conduct of business. The UCITS framework would also be amended to ensure that direct sales by UCITS asset managers are subject to the MiFID regime.

The consultation does not provide any significant departure from the Commission’s previous proposed approach in relation to the selling rules for PRIPs. However, the bulk of the detail will be set out in the reviews of MiFID and the IMD, with the result that some of the more difficult issues are not considered in the consultation. In particular, one issue which is not dealt with is whether it should be possible for PRIPs to be sold on a non-advised basis to retail investors and whether, in such circumstances, a MiFID appropriateness assessment must be carried out considering the knowledge and experience of the investor. Although many PRIPs are likely to be categorised as complex products and therefore not available for the execution-only exemption from the MiFID appropriateness test, UCITS products are currently automatically treated as non-complex. This will be an important area of the consultation in respect of the MiFID review. In its consultation paper dated 8 December 2010,<sup>7</sup> the Commission stated it is considering abolishing the execution-only exemption under MiFID.

### Next Steps

The consultation is open for public comments until 31 January 2011. The Commission will use the feedback received to fine-tune its legislative proposals for the new PRIPs regime which it is expected to publish in 2011. As highlighted above, it proposes that detailed consultation in relation to the sales rules should be carried out in connection with the ongoing review of MiFID and the IMD.

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<sup>6</sup> Insurance Mediation Directive (2002/92/EC), [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l\\_009/l\\_00920030115en00030010.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l_009/l_00920030115en00030010.pdf).

<sup>7</sup> European Commission Public Consultation: Review of the Markets in Financial Instruments Directive (MiFID) (8 December 2010), [http://ec.europa.eu/internal\\_market/consultations/docs/2010/mifid/consultation\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf) (comments deadline: 2 February 2011).

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