

# Prips: the road to legislation

*Morrison & Foerster's Peter Green and Jeremy Jennings-Mares provide an update on EC progress as it gears up to issue Prips regs.*

It has been almost three years since the European Commission's work began in relation to the regulation of packaged retail investment products (Prips) and there is still some way to go before the new legislation is finalised and comes into force.

The EU Commission has conducted extensive consultation in relation to substitute investment products since issuing a call for evidence on the need for a coherent approach to product transparency and distribution requirements in October 2007. This led to a communication on Prips in April 2009. A further period of consultation with market participants followed and the Commission is expected to publish an outline of its legislative proposals within the next few months.

The EU Commission is not concerned that there is currently a material lack of regulation for Prips. Most of the products that would generally be regarded as falling into this group are already regulated, either at the EU or domestic level. It is dissatisfied, however, that the regulatory requirements may vary significantly, depending upon the legal nature of the product and the way in




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which it is marketed and distributed to investors.

Although the Commission accepts that certain distinctions are necessary, because some products are developed to meet local taxation requirements or local investor expectations, it considers there is considerable benefit in developing a more harmonised framework for Prips to provide a more consistent basis of regulation.

With detailed regulatory rules still a way off, there has already been considerable discussion as to which products should fall within the new regime. The Commission's stated aim is that Prips should be categorised in a way that is flexible enough to accommodate further innovation but limits opportunities for regulatory arbitrage.

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It has therefore set out certain key features it believes pertain to Prips, including that the product be linked to the performance of one or more underlying assets and that the investor fully or partially bears the investment risk. It does not believe pure protection products such as credit default

swaps or insurance policies should fall within the definition. Among the products that are likely to fall within the definition are structured notes (including credit, equity and fund-linked notes), structured term deposits, Ucits (Undertakings for Collective Investments in Transferable Securities) and other mutual funds, and some life insurance products.

During the consultation process, many market participants, including trade bodies such as the Joint Associations Committee, have urged the EC Commission to focus on the type of investor to whom the product is primarily marketed, particularly in determining whether or not the product is a retail product. It has been suggested that an over-emphasis on the legal form of the product could result in additional disclosure being required in relation to products that will be primarily marketed and sold to wholesale and sophisticated investors, thereby unnecessarily increasing costs.

The two other key areas focused on so far by the Commission are product disclosure and selling practices. In relation to product disclosure, the Commission has expressed concern about the quality of existing disclosures and whether they enable investors to properly understand the products they are investing in and the risks associated with them. The Commission's proposal seeks to ensure that product disclosure is comprehensible to retail



investors, enabling them to make meaningful comparisons between different products and an informed investment decision about the individual product.

The Commission proposes that disclosure be made in a key information document (Kid) using the key investor information requirements recently approved in the new Ucits Directive as a benchmark. It does, however, recognise that the Ucits requirements will require considerable adaptation before being suitable for the wide range of Prips; it is unlikely that a single Kid template can be adopted for use across all products.

In relation to selling practices, the Commission believes there should be a consistent set of standards as to conduct of business rules, inducements and conflicts. It regards the existing Mifid rules as the appropriate benchmark in this case. In particular, it will

be interesting to see how the Commission intends to apply the Mifid suitability test, relevant to advised sales, and the appropriateness test, relevant to non-advised sales, generally across Prips. For non-advised sales, Ucits and other non-complex products are currently eligible for an execution-only exemption from the need to perform an appropriateness test. Any Prip that is not a Ucits but embeds a derivative is, however, likely to be regarded as a complex product and not eligible for the exemption. This issue is likely to be the subject of additional consultation and is also relevant to the EU Mifid review in 2010.

Although there is support in the market for a more consistent regulatory approach across retail products, the message from market participants that has emerged during the consultation process is that any new requirements should not materially increase costs or impose overly prescriptive rules on manufacturers and distributors of Prips. There are some challenging issues for the EU Commission to address in formulating its detailed legislative proposals. The future development of the market is likely to be significantly affected by the legislative measures which are ultimately introduced. **SRP**

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