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UK FINANCIAL CONDUCT AUTHORITY CALLS FOR INPUT ON PRIIPS

On July 26, 2018, the Financial Conduct Authority (FCA) of the United Kingdom issued a Call for Input[1] in relation to the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation[2] and the related PRIIPs Regulatory Technical Standards (RTS)[3] which took effect in January 2018.

The PRIIPs legislation requires the production of a standardized key information document (KID) whenever a product within the scope of the PRIIPs legislation is being sold or recommended to retail investors in the European Economic Area (EEA), irrespective of where the manufacturer or distributor of the in-scope product is located or regulated. Therefore, this Call for Input will be of interest to, among others, all manufacturers of PRIIPs and those who advise on or distribute PRIIPs within the EEA. The FCA considers that this will include issuers of securities that are classed as PRIIPs, life insurance companies, discretionary investment management firms, firms providing services in relation to insurance-based investments,

[1] https://www.fca.org.uk/publications/calls-input/priips-regulation-initial-experiences-new-requirements.
[2] Regulation (EU) No. 1286/2014.
[3] Commission Delegated Regulation (EU) 2017/653.

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fund managers, wealth managers, brokers and other firms that provide advice to retail clients, financial advisers, and firms operating retail distribution platforms.

The Call for Input relates to the scope of the PRIIPs Regulation (Regulation), and, in particular, whether certain products are in or out of scope of the PRIIPs Regulation, and also to the cost and risk disclosure requirements in the PRIIPs legislation. In addition, the FCA also invites input on any other practical experiences that market participants have had with the remaining parts of the PRIIPs legislation.

The FCA requests all interested market participants provide input and any accompanying evidence by September 28, 2018. Thereafter, it aims to publish a feedback statement in early 2019 and use the responses to inform its engagement with the three European Supervisory Authorities, and other national competent authorities in the EEA.

THE SCOPE OF THE PRIIPS REGULATION

Ever since the PRIIPs Regulation was passed in 2014, market participants have struggled with the issue of exactly which products are within the scope of the regulation.

The definition of a PRIIP, as contained in Article 4 of the Regulation, is extremely broad and essentially encompasses:

- any investment where, regardless of the legal form of the investment, the amount repayable to the retail 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 retail investor; and
- any insurance product which offers a maturity or surrender value that is wholly or partially exposed, directly or indirectly, to market fluctuations.

Although Article 2 of the Regulation specifies a list of certain products to which the Regulation does not apply, the European Commission has never produced a list, or more specific definition, of products that do fall within the scope of the Regulation. This is despite requests from market participants for further guidance from the European Commission and/or the European Supervisory Authorities on the scope of the Regulation. Guidelines from the European Commission have made clear that it is the manufacturers and distributors of products who are responsible for assessing whether the products are within the scope of the Regulation, and that the assessment must take into account the specific economic features and contractual terms and conditions of each product.

The FCA has gone further and published on its website both a list of products that it considers to be within the scope of the Regulation and a list of those that it considers are not.

The FCA makes it clear that investment funds (whether regulated or not) are subject to the Regulation, as well as structured products and structured deposits, derivatives, some non-pension annuities, and many insurance-based investment products.

Contained on the list of out-of-scope products are deposits (other than structured deposits, as defined in the MiFID II Directive[4]), debentures, and other debt securities where the amount repayable to the investor is fixed.

Despite these two lists, there are many financial instruments and contracts that are not featured on either list which have a status that is regarded as unclear by many market participants. In the Call for Input, the FCA highlights certain corporate bonds, such as those that are callable together with payment of a make-whole amount. Although not highlighted by the FCA, one could add to this category certain bonds with step-up coupons (depending on the circumstances leading to the step-up) and floating rate or fixed/floating rate bonds. For instance, a bond with a coupon linked to an interest rate index, such as LIBOR or a swap rate, appears to fall within the broad PRIIPs definition above, because the amount repayable to the investor is subject to fluctuations from exposure to a reference value. However, a deposit with an interest rate linked to LIBOR does not fall within the definition of a structured deposit (as contained in the MiFID II Directive) and is therefore expressly outside the scope of the PRIIPs Regulation. The only relevant distinction between a LIBOR linked deposit and a LIBOR-linked bond is that one is expressly excluded from the PRIIPs Regulation and one is not. However, there is no logic to this differentiation, given that both are fixed income products and the PRIIPs Regulation expressly considers all investment products "regardless of the legal form of the investment."

The FCA notes that non-compliance with the PRIIPs legislation can incur penalties and as a result, recent bond market data indicate that there has been a significant decline in firms issuing certain bonds to retail investors in the primary market and in distributors selling certain bonds to retail investors in the secondary market. The FCA also notes industry reports suggesting

[4] Directive 2014/65/EU.

there is uncertainty as to whether some other products, such as UK real estate investment trusts and certain foreign exchange contracts, are in or outside the scope of the Regulation.

Therefore, the FCA is particularly interested in receiving input from providers, distributors and investors to assess the nature and extent of scope issues such as these and possible impacts on behavior in the markets. In particular, they have asked if there are examples of product types where there is uncertainty as to whether they are in scope and whether the respondents have tried to resolve this uncertainty.

CONTENTS OF A KEY INFORMATION DOCUMENT (KID)

For those manufacturers of PRIIPs that have continued to focus on retail investors in the EEA since January 2018, the FCA invites them to provide evidence of practical challenges they have encountered in calculating information to be disclosed in the KID. The FCA also invites investors to describe their experience using KIDs when making investment decisions.

COSTS DISCLOSURE

When calculating and disclosing transaction costs in the KID, firms must include implicit transaction costs in the price of a transaction and the RTS have prescribed methodologies to calculate those costs. The methodologies include:

- an "actual transaction costs" methodology, which the FCA describes as "slippage." This methodology must be followed where the PRIIP has been operating for at least three years and investing in underlying assets consisting of instruments for which there are frequent trading opportunities and publicly available pricing information (these PRIIPs are typically investment funds);
- an "estimated costs" methodology, which must be followed for PRIIPs investing in underlying assets other than liquid instruments; and
- a "new PRIIPs" methodology, which may be followed where a product has been in operation for less than three years.

The FCA is aware of concerns from firms about the practical application of the slippage methodology – in particular, that some funds are disclosing negative transaction costs.

The FCA understands that firms may be experiencing difficulties in calculating transaction costs associated with transactions in over the counter (OTC) instruments, in particular non-standardized OTC derivatives.

As a result, the FCA has asked for input as to whether PRIIPs manufacturers have experienced calculations of transaction costs under the slippage methodology which led to negative, zero, or unexpectedly large transaction costs and, if so has requested examples, together with a full calculation of how the output has been obtained and an explanation of any assumptions.

Depending upon the findings, the FCA has said that it will consider running workshops to support firms in their compliance activities in relation to these requirements, but where the FCA sees non-compliance with the requirements, it will consider appropriate supervisory and enforcement action.

The FCA has also requested input as to the experience of investors with disclosures of transaction costs and whether those disclosures have been helpful to them when making their investment decisions, or whether some costs disclosures have been difficult to understand.

RISK DISCLOSURE

One of the requirements of the KID is disclosure of the risks involved in the PRIIP, including a summary risk indicator (SRI) which needs to be supplemented by a narrative explanation of the indicator and its main limitations, together with a narrative explanation of the risks which are materially relevant to the PRIIP but which are not adequately captured by the SRI.

The FCA is aware that some product providers have concerns that the SRI might in some cases be misleading, either because the risk of the product does not appear to be adequately captured by the SRI or because the product has a significantly different SRI from other economically equivalent products.

Therefore, the FCA has requested comments on the SRI and the extent to which the required components of the risk narratives are able to adequately explain the risks of a product to investors. They also request any examples of products with prescribed methodologies for assessing and presenting risk that lead to a counter-intuitive or potentially misleading SRI.

PERFORMANCE SCENARIOS

PRIIPs manufacturers are required to include appropriate performance scenarios in a KID under the headings "Favourable," "Moderate," "Unfavourable," and "Stressed" together with information about the assumptions made to produce them.

The FCA states that it is aware of two specific issues in performance scenarios, which may end up giving a misleading impression to investors. It refers to a statement that it gave in January 2018[5] stating that where a PRIIPs manufacturer is concerned that its performance scenarios in the KID are too optimistic, and at risk of misleading investors, it may provide explanatory materials to put the calculation in context, and similarly that firms distributing PRIIPs may consider providing additional explanations to their clients when they are concerned that a particular KID may mislead their clients.

The FCA now asks for input as to whether manufacturers and distributors have experienced any practical issues in the calculation and presentation of performance scenarios in a KID, in particular any practical difficulties not fully contemplated in their January 2018 statements. They are also interested in hearing from consumers who are using KIDs and who have encountered any issues with the performance scenarios presented to them.

GENERAL

As a general matter, the FCA is particularly interested in feedback from firms and investors about their overall experience in preparing, providing, or using a KID, such as how the KID is presented, the prominence of information in it, examples of where the mandatory content may cause issues, how the KID is provided in practice, and how the KID and supplementary materials are working for multi-option products.

ESMA TEMPORARY PRODUCT INTERVENTION MEASURES

As we previously reported in Volume 9, Issue 3, of Structured Thoughts[6], the European Securities and Markets Authority (ESMA) took a decision to impose temporary product intervention measures on the provision of contracts for differences (CFD) and binary options to retail investors. Subsequently, ESMA published two decisions in this regard, which were published in the Official Journal of the EU on June 1, 2018. The effect of these decisions was to prohibit the marketing, distribution or sale of binary options to retail clients, with effect from July 2, 2018, for a period of three months and to restrict the marketing, distribution or sale of CFDs to retail clients, so that they can be sold only if they observe various conditions, including the leverage limits and margin close-out and negative balance protection provisions specified in our previous piece. The restriction on CFD sales became effective as from August 1, 2018, for a period of three months.

ESMA has also issued a set of Questions and Answers[7] in connection with these temporary product intervention measures, in which document it makes clear that the product intervention measures apply to EU firms, whether the retail client in question is from inside or outside the European Union.

On August 1, 2018, the UK's Financial Conduct Authority (FCA) also issued a statement supporting the ESMA product intervention measures in relation to CFDs. The FCA went on to state that other products can create the same kinds of risks to consumers as CFDs, particularly where they involve significant leverage, and that it has concerns that firms may consider circumventing the ESMA product invention measures by selling other similarly complex products to retail clients, in particular Turbo Certificates. Therefore, the FSA will work with ESMA and other European regulators to continue monitoring and assessing the sale of alternative, speculative products to retail clients and will consider with ESMA whether to take further action to extend the scope of the product intervention measures if it obtains evidence that these alternative products are causing similar harm to CFDs.

SEC ISSUES INVESTOR ALERT ABOUT NON-TRADITIONAL INDEX FUNDS

On August 6, 2018, concurrent with their release of an investor alert regarding index funds[8], the United States Securities and Exchange Commission (the "SEC") issued an investor alert (the "Investor Alert") to inform investors about features and potential risks associated with non-traditional index funds[9].

Non-traditional index funds are mutual funds or ETFs that pursue alternative investment strategies, which are described by the SEC as funds with "more complex or

[5] https://www.fca.org.uk/news/statements/statement-communications-relation-priips.

[6] https://media2.mofo.com/documents/180416-structured-thoughts.pdf.

[7] https://www.esma.europa.eu/press-news/esma-news/esma-publishes-qas-in-relation-temporary-product-intervention-measures.

[8] Investor Alert, available at: https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_indexfunds.

[9] Investor Alert, available at: https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_smartbeta.

targeted investing strategies than have been traditionally associated with index funds." Non-traditional index funds track custom-built indices, which are constructed using criteria different from a traditional market cap-based approach (used in more typical broad market indices). Customized approaches used in selecting their investments, as illustrated by the Investor Alert, include smart beta (or alternative beta) approaches where funds use factors such as divided performance, quant approaches where funds use mathematical formulas based on advanced quantitative analysis, and Environmental, Social and Governance (ESG) approaches that focus on sustainable, socially conscious investing. While non-traditional index funds are still passively managed, their underlying investment decisions are made similar in some ways to what an investment manager may consider when actively managing a fund.

The Investor Alert reminded investors that non-traditional index funds could differ from more traditional index funds, in particular with respect to their risk profile. In addition to the standard risks associated with investing in an index fund, the SEC warns that those who wish to invest in non-traditional index funds would face additional considerations given their complex and difficult features. For example, their investment strategy may be difficult for an investor to understand or evaluate, and may cause these funds to underperform in the broader markets. In addition, non-traditional index funds tend to have limited performance history given their customized nature and incur higher expense ratios compared to traditional market-based index funds.

While non-traditional index funds are still a relatively new method of investing, the Investor Alert acknowledges their increasing prominence in the market. The SEC's concerns relate as well to structured notes and structured CDs that are linked to proprietary indices. The SEC's release of the Investor Alert seem to suggest that the SEC is keen on closely monitoring the progress of these new types of products and that they want the issuers and the distributors of these products to be aware that they are watching.

THE RETURN OF GARY PLASTICS

A securities law riddle: When does an instrument that is not a security become a security?

For example, Section 3 of the Securities Act of 1933 establishes that a certificate of deposit is not a "security." However, there have been circumstances in which the courts have been willing to characterize CDs as securities. In *Gary Plastics Packaging v. Merrill Lynch, Pierce, Fenner, & Smith Inc.*, 756 F.2d 230 (2d Cir. 1985), Merrill Lynch marketed insured CDs that it had purchased from various banks. Merrill Lynch allegedly promised to maintain a secondary market to guarantee purchasers liquidity for their deposits, and represented to purchasers that it had reviewed the financial soundness of the issuing banks. Due to the fact that the broker's creation and maintenance of a secondary market was a critical part of its marketing efforts, and marketing permitted investors to make a profit from these investments, the court determined additional protection of the Securities Act was appropriate.

In its analysis, the Second Circuit Court of Appeals analogized CDs to "investment contracts." An instrument is an "investment contract" if it evidences: (1) an investment; (2) in a common enterprise (3) with a reasonable expectation of profits; and (4) to be derived from the entrepreneurial or managerial efforts of others. Due to the fact that the broker's creation and maintenance of a secondary market was a critical part of its marketing efforts, and the marketing was designed to enable investors to profit from these investments, the additional protection of the Securities Act was deemed appropriate.

This analysis reemerged in several recent situations. The first example, was a situation that, like the Gary Plastics case, involved CDs. In a 2018 SEC enforcement action,[10] the SEC took the position that structured certificates of deposit offered by a broker-dealer could be treated as "securities" where (a) certain of the broker-dealer's representatives had a practice of soliciting advising investors to redeem their CDs for the purpose of reinvesting the proceeds in new CDs, and (b) investors relied on the early broker-dealer to make a market for the CDs and to serve as the source of prices for these instruments.

In addition, in June 2018, Director William Hinman, of the SEC's Division of Corporation Finance delivered a speech at the Yahoo Finance All Markets Summit: Crypto.[11] In fact, the title of the speech included a specific reference to the *Gary Plastics* case, and was entitled: "Digital Asset Transactions: When Howey Met Gary (Plastic)." In the speech, Director Hinman noted that a digital asset, in and of itself, may not be a security. However, depending upon the manner in which it is sold, and the expectations of the investors, an asset of this kind

[10] The SEC order can be found here: https://www.sec.gov/litigation/admin/2018/33-10511.pdf.
[11] The text of the speech can found here: https://www.sec.gov/news/speech/speech-hinman-061418#ftn1.

can become an investment contract, and therefore be within the scope of the securities laws and the SEC's jurisdiction. In a case of this kind, the purchaser's ability to realize a profit depends on the success of the enterprise and the ability to realize a profit on the investment turns on the efforts of a third party.

The markets continue to evolve, and new instruments and distribution methodologies emerge. Every instrument and offering needs to be carefully examined to determine the extent to which the federal securities laws can be deemed to apply — no matter what the name or apparent form of the instrument is.

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