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Financial Services and Markets

PRIPs – the new KID in town?

Last month the European Commission published its proposal for a Regulation for packaged retail investment products, the PRIIPs Regulation. With amendments to the Insurance Mediation Directive and UCITS, the Regulation forms part of a package of legislative proposals regarding consumer protection in financial markets. Central to the proposal is the requirement that investment product manufacturers should be required to prepare and publish a Key Information Document (KID) for those products which they propose to make available to retail investors (and distributors should make the KID available to such investors). The concept is not that new: it is largely derived from the UCITS Key Investor Information Document (KIID), although there are some differences. The Regulation, which will be supplemented by delegated acts and regulatory standards that have yet to be published, will come into force two years after its adoption. It will be directly applicable in the UK without any requirement for national legislation.

The Commission is currently expecting the PRIIPs requirements (i.e. the Regulation and its delegated acts and regulatory technical standards) to be effective by the end of 2014.

The draft Regulation is available [here](#).

Background

Under the PRIIPs Regulation an investment product manufacturer will be required to prepare and publish a Key Information Document (KID) for any investment product which it produces before that product can be sold to retail investors. The prototype for the KID is the UCITS Key Investor Information Document (KIID).

The purpose of the KID is to improve transparency for retail investors by providing them with a short document which contains the key information about a product to enable them to make informed investment decisions and which is presented in a common format that will allow investors to more easily compare different investment products.

The KID will be an additional document over and above documentation prepared to meet other requirements in the Prospectus Directive or Solvency II.

What products are caught?

The Regulation applies to "investment products". The intention is to capture a wide variety of packaged products, indirect holding mechanisms and derivative instruments across different industry sectors sharing (as the Commission's explanatory memorandum puts it) a common and relatively simple need: capital accumulation that beats the risk-free rate.

An "investment product" is:

"an investment where regardless of the legal form of the investment the amount repayable to the investor is exposed to fluctuations in reference values or in the performance of one or more assets which are not directly purchased by the investor."

The underlying assets on which the performance of the investment product is based may or may not be investments or financial instruments.

Investment products for the purposes of the Regulation will include:

- investment funds and other collective investment vehicles – whether closed-ended or open-ended, whether UCITS or non-UCITS;
- life insurance policies with an investment element – including linked policies and with-profits;
- structured products, whatever their form (including structured deposits, SCARPs and structured investment products); and
- derivative instruments.

It will be seen that the definition does not include any express reference to "packaging", although the wording seeks to capture the concept by reference to the investor not having a direct holding in underlying assets. There is also no reference to the retail nature of the product in the definition – however, the obligations on product manufacturers and sellers will only bite before selling an investment product to "retail investors" (see below).

What products are not caught?

Certain investment products are expressly excluded from the scope of the Regulation:

- insurance products where the surrender value is not in any way exposed to market fluctuations (this will include pure protection contracts and non-life insurance products);
- deposits with a rate of return determined by an interest rate – i.e. non-structured deposits whose return is determined by an interest rate such as EURIBOR or LIBOR;
- certain categories of securities which are excluded from the Prospectus Directive (including, for example, government or public debt securities, securities guaranteed by a Member State, securities issued by associations or non-profit making entities and certain non-equity securities issued in a continuous or repeated manner by credit institutions);
- other securities which do not embed a derivative – i.e. "plain vanilla" equities and debt instruments;
- occupational pension schemes; and
- personal pension products where a financial contribution from the employer is required by national law and the employee has no choice as to the pension product provider (this will cover group personal pension arrangements).

"Securities" is not a defined term. The recitals to the draft Regulation state that assets which are held directly, such as corporate shares or sovereign bonds, are not packaged investment products and should be excluded. The explanatory memorandum refers to the "securities" exclusion applying to shares and bonds insofar as these do not contain a mechanism other than a direct holding of the relevant assets.

UCITS are exempt from the requirements of the Regulation for a period of five years after the PRIPs Regulation comes into force. This reflects the fact that UCITS are already subject to a substantively similar requirement in the form of the recently-introduced KIID and it would not be proportionate to apply the KID at this stage. The Commission will consider, as part of its review of the Regulation four years after it comes into force (see below), whether the UCITS transitional arrangements should be extended beyond the five years or whether the KIID should be replaced by the KID.

Who is caught by the Regulation?

"Investment product manufacturers" and any person selling an in-scope investment product will be subject to the requirements of the Regulation, to the extent that such product will be sold to retail investors.

The investment product manufacturer is the natural or legal person who manufactures the investment product or who makes changes to an existing investment product by altering its risk and reward profile or the costs associated with the investment product.

A recital gives the example of fund managers, insurance undertakings, issuers of securities, credit institutions or investment firms, but otherwise the broad definition is not subject to any further clarification. In many cases the identity of the manufacturer will be uncontroversial, but for some products (particularly those structured with their own separate legal personality, such as investment trusts) there may be ambiguity – would the manufacturer be the product vehicle itself, its promoter/sponsor/broker or the investment manager?

What is the obligation on investment product manufacturers?

An investment product manufacturer is required to draw up a KID in accordance with the requirements of the Regulation for each investment product it produces and the document must be published on a website of its choice *before* the investment product may be sold to retail investors.

The wording of the Regulation might be taken to imply that the requirement to draw up the KID applies in relation to *any* investment product (i.e. regardless of the target investor base) and that it is the publication requirement which is engaged only when there is a likelihood that the product will be sold to retail investors. However, a recital makes it clear that where a product is not sold to retail investors it is not necessary to draw up a KID.

That said, while it may be possible to control and limit access to some products so that no retail investors can buy them, for others (particularly listed entities) this will be more difficult, if not impossible. Many investment product manufacturers will have to ensure that a KID is drawn up and published on a website if there is a likelihood that their products will be bought in the retail sector, even if that was not their intended or primary market. See also our comments below in relation to who will fall into the category of "retail investor".

The distribution of the product is therefore key in determining to what extent the product manufacturer is subject to the obligation to draw up and publish a KID.

What is a "retail investor"?

The term captures "retail clients" as defined under the Markets in Financial Instruments Directive (i.e. clients who are not *per se* professionals or elective professionals). It also captures "customers" under the Insurance Mediation Directive (IMD) although, oddly, there is no specific definition of "customer" under the IMD.

As mentioned above, a recital in the Regulation states that it is not necessary for a manufacturer to draw up a KID in respect of a product that is not sold to retail investors. However, since the obligation to draw up and publish the KID must be fulfilled *before* the investment product can be sold to retail investors, it will only be safe *not* to prepare a KID prior to the distribution of an investment product where the manufacturer is certain that no retail investors will invest. It is difficult to envisage circumstances in which high net worth individuals and sophisticated investors will not fall within the definition of "retail investors" – the concept of "opting up" individuals to elective professional client status (which is far from easy for an investment firm categorising its clients under MiFID) does not look practical in the context of product manufacturers and potential end-investors. This, and the uncertainty as to the scope and meaning of "customers" under the IMD, is likely to mean that most manufacturers of in-scope investment products would be advised to prepare and publish a KID in advance of any distribution.

The Form and Content of KID

The Regulation sets out some high level principles for the content of the KID and prescribes in general terms the information to be provided. The approach is very similar to that adopted for UCITS KIIDs. The detailed requirements will be set out in the Commission's delegated acts and in regulatory technical standards which will follow.

High-level principles

In terms of the high level principles, the KID must be:

- accurate, fair, clear and not misleading;
- a stand-alone document, clearly separate from marketing materials;
- a short document;
- presented and laid out in a way which is easy to read, using characters of readable size;
- clearly expressed, using language that facilitates the retail investor's understanding (avoiding the use of jargon and technical terms).

Presentation

Any use of corporate branding or a logo by the investment product manufacturer must not distract the retail investor from the information in the KID or obscure the text. If colours are used, the information should still be comprehensible if the KID is copied or printed in black and white.

Language

The KID should be written in an official language of the Member State where the investment product is sold or in a language accepted by the competent authorities of that Member State. This means that where an investment product produced by a UK manufacturer is to be sold in another Member State and English is not accepted by the relevant competent authorities in that State the document will need to be translated.

Prescribed headings and information

From a content perspective, the Regulation prescribes the section headings for each part of the KID with a brief description of what each section should include. The Regulation requires KIDs to have a common format, adopting a standardised order for the presentation of information to allow for ease of comparison and to include a common symbol to distinguish the KID from other documents. Additional information should only be included where it is necessary for the retail investor to make an informed investment decision.

Following Articles 8(1) and 8(2) of the Regulation, the prescribed format of the KID and an outline of the key information requirements is as follows:

[KID common symbol]
Key Information Document
<p>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.</p>
Name of investment product:
Name of investment product manufacturer:
What is this investment?
[The nature and main features of the product to be set out including:
<ul style="list-style-type: none"> • the type of investment product; • its objectives and the means for achieving them; • whether the investment product manufacturer targets specific environmental, social or governance outcomes (in respect of its business or in respect of the investment product) and if so, an indication of the outcomes being sought and how these are to be achieved; • for an insurance product, details of the insurance benefits; • the term of the investment product, if known; • performance scenarios if relevant to the product.]
Could I lose money?
[Provide an indication of whether loss of capital is possible, including any guarantees or capital protection provided and whether the investment product is covered by a compensation or guarantee scheme.]
What is it for?
[Provide an indication of the recommended minimum holding period, expected liquidity profile for the product, the possibility and conditions for any disinvestment before maturity.]
What are the risks and what might I get back?
[This section should cover the risk and reward profile of the investment product, including a summary indicator and warnings in relation to any specific risks that may not be fully reflected in the summary indicator.]
What are the costs?
[This section should include the costs associated with an investment comprising both direct and indirect costs, including summary indicators of the costs.]
How has it done in the past?
[This section should set out the past performance of the investment product, if relevant, having regard to the nature of the produce and the length of its track record.]
[What might I get when I retire?
[This will obviously be relevant to pension products only, and should contain projections of possible future outcomes.]

The detailed requirements will be set out in delegated acts and regulatory technical standards. It is expected that the UCITS KIID requirements (including the Synthetic Risk and Reward Indicator and ongoing costs calculation methodology) will be the starting point for the development of these detailed rules, accepting that there will need to be further tailoring for different product types.

How often should a KID be reviewed and updated?

The starting position is that the investment product manufacturer should review the KID regularly and revise it where changes need to be made.

However, the Commission will lay down detailed rules for the review and updating of the KID in delegated acts, including the circumstances in which retail investors are to be informed about a revised KID for an investment product already purchased by them. The delegated acts will also cover the requirements for the KID to be reviewed or revised where an investment product is made available in a non-continuous manner.

What is a manufacturer's liability for the KID?

If an investment product manufacturer produces a KID which does not comply with the requirements of the Regulation and a retail investor has relied on it when making an investment decision, the retail investor may claim damages for any loss caused through the use of the KID.

There is a specific provision reversing the burden of proof to be applied. The retail investor only needs to demonstrate that it has suffered a loss resulting from the use of the information contained in the KID; having done so, it is then for the investment product manufacturer to then prove that the KID was drawn up in compliance with the Regulation.

On the face of it, provided the investment product manufacturer has complied with the requirements of the Regulation as regards the content of the KID and its publication, the manufacturer should not have any liability (at least under the provisions of the Regulation) for the failure of a seller in complying with the obligations imposed on it.

What are the obligations on sellers of investment products to retail investors?

Provision of KID: timing

A person selling an investment product to retail investors must provide them with the KID "in good time before the conclusion of a transaction" relating to the investment product. Where there are successive transactions in the same product in accordance with the investor's instructions at the outset the KID need only be provided once.

In the case of contracts concluded by means of distance communication, the KID can be provided immediately after the conclusion of the transaction if it is not possible to provide it before then and the person selling the investment product has informed the retail investor of this fact.

Again, the Commission is to be empowered to specify in delegated acts the conditions for fulfilling the requirement to provide the KID "in good time" and the method and time limit for the provision of the KID when the contract is concluded by means of distance communication.

No cost

The KID must be provided to retail investors free of charge.

Medium

The KID must either be provided on paper or using a durable medium other than paper (subject to certain conditions) or by means of a website which meets certain prescribed website conditions.

If the KID is provided using a durable medium other than paper or through a website, a paper copy must be provided to the retail investor upon request and free of charge.

The conditions for the use of a durable medium other than paper follow the requirements set out in other directives, such as MiFID and UCITS (in that the use of the durable medium must be appropriate in the context of the business), but it is a condition that the retail investor is given the choice between information on paper and the durable medium *and has positively chosen the other durable medium*.

The conditions for the use of a website similarly follow the requirements in other directives such as MiFID and UCITS, so that:

- the use of a website must be appropriate in the context of the business between the seller and the retail investor;
- the retail investor has consented to the use of a website;
- the retail investor has been notified electronically of the address of the website and where on the website the KID may be found;
- all revised versions of the KID must also be made available;
- the KID must remain accessible on the website for such period of time as the retail investor may reasonably need to consult it.

Where the KID is to be provided via a durable medium other than paper or on a website, this will be considered as appropriate in the context of the business between the seller and the retail investor if it can be shown that the latter has regular access to the Internet – access to the Internet will be evidenced by a e-mail address. Since not all retail investors may choose to receive the

information in non-paper form and/or have access to the Internet, it is unlikely that a seller will be able to rely on having the KID only on a website and will therefore need to be prepared to provide paper copies.

Complaints and redress procedures

Investment product manufacturers must establish procedures which ensure that retail investors who have a complaint in relation to the KID receive a substantive reply in a timely and proper manner.

There is also an obligation on the investment product manufacturer, or the person selling the investment product, to participate in any national alternative dispute resolution procedures initiated by the retail investor if such procedures meet certain conditions (including the suspension of any limitation period during the dispute resolution procedure). Member States are to notify the Commission of the entities operating any alternative dispute resolution processes that comply with these requirements.

Sanctions

In addition to the liability that investment product manufacturers will have to retail investors that have suffered loss, both manufacturers and sellers will be subject to administrative sanctions for breach of the Regulation's requirements.

Member States will be required to establish and implement appropriate sanctions for breaches of the Regulation which should be effective, proportionate and dissuasive. For breaches of the substantive requirements in the Regulation, the competent authorities in each Member State should have the power to impose at least the following measures:

- an order prohibiting the marketing of an investment product;
- an order suspending the marketing of an investment product;
- a public warning which identifies the person responsible and the nature of the breach;
- an order for the publication of a new version of a KID.

The competent authorities would also have the power to require the investment product manufacturer or person selling the investment product to issue a direct communication to the retail investors concerned giving them information about the sanction and informing them where to lodge complaints or submit claims for redress.

Sanctions imposed for breach of the Regulation are to be disclosed to the public without undue delay unless the disclosure would seriously jeopardise the financial markets. If the publication would cause "disproportionate damage" to the party or parties involved, the competent authority is required to publish the sanction on an anonymous basis.

Given the potential application of the Regulation to certain vehicles not currently subject to direct FSA regulation, it will be interesting to see how the UK complies with these requirements.

Marketing Communications

As stated before, it is fundamental that the KID is not itself a marketing document. Any marketing communication which contains specific information about the investment product must not contradict the KID or diminish the significance of the KID. All marketing communications should state that the KID is available and indicate how to obtain it.

The term "marketing communications" is not defined or further elaborated on. Nor is it clear to whom this obligation is attached – investment product manufacturers will be subject to this requirement but its ambit is potentially much wider.

What happens next?

The proposed Regulation will now be considered by the European Parliament and Council under the codecision procedure. The Commission has said that it expects the Regulation (together with the delegated acts and regulatory technical standards) to be effective by the end of 2014.

The drafts of the delegated acts and regulatory standards will be published in due course. There is currently no precise indication of when this will be (ESMA's 2012 work programme suggests that the technical standards will be delivered in Q.4 although this appears ambitious).

The Commission will review the Regulation four years after it comes into force. In addition to considering whether UCITS should become subject to the KID obligation, the review will also consider a possible extension of the scope of the Regulation to other financial products.

For further information on the PRIPs Regulation and the KID requirements, please contact one of the following lawyers in our Financial Services and Markets Department or your usual contact at Travers Smith.

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