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Implementing PRIIPs – the uncertainty persists

It is now less than six months until PRIIPs, the EU Regulation on Packaged Retail and Insurance-based Investment Products (the Regulation), comes into force and much remains to be done in preparation for its implementation.

The Regulation obliges manufacturers of a PRIIP, such as credit institutions, investment firms, fund managers, insurance companies and exchanges, to produce a clear, concise document – the Key Information Document or KID – where such products are made available to retail investors. The regime sets out rules for the content and format of the KID, as well as for its review and the timing for delivery. In addition, 'any person advising on or selling a PRIIP', which may be the PRIIP manufacturer itself for direct sales, or distributors and intermediaries for indirect sales, also has to comply with the PRIIPs regime.

Although the main aim of the Regulation is straightforward – to make it easier for retail investors to compare products and make a more informed investment decision – achieving this in practice is proving much more difficult. PRIIPs is a complex and technical regulation that presents a number of practical and quantitative challenges and even at this late stage there are a number of questions that remain unanswered. The European Commission (the Commission) held a workshop for stakeholders on the implementation of the PRIIPs framework on 11 July 2016 (the workshop). It is hoped that the questions that were raised and the issues that remain will be addressed in the coming weeks.

Uncertainty on how best to tackle these issues has hindered implementation plans and prompted calls from the industry for the date of application to be pushed back by one year to December 2017. As yet these calls remain unheeded. However, in response to industry concerns about the very tight timeframe, the European Supervisory Authorities (the ESAs) have announced that they intend to issue Level 3 guidance, in the form of Q&A, 'in the course of this summer', to aid implementation and consistent supervision by the regulators of the regime. This means that the Q&A will be published before the end of the objection period for the PRIIPs regulatory technical standards (RTS), which were adopted by the Commission on 30 June 2016, but this is considered necessary because of timing concerns.

There are a significant number of outstanding issues on the Regulation, as discussed in the workshop, including issues around scope, costs, risk disclosures and performance scenarios. In this briefing, we focus on the scope of the Regulation and outline some of the key issues which have created uncertainty for firms striving to implement the Regulation by the December 2016 deadline.

For more information on the Regulation see our client briefing 'The PRIIPs KID Regime'.

Product scope

One of the biggest hurdles for the market has been determining which products are 'PRIIPs', which means deciding whether a particular product comes within the broad definition of 'packaged retail investment products' or 'insurance based investment products', as set out in the Regulation. The Commission and the ESAs have confirmed that they will not publish a list of in/out of scope products as part of the Level 3 guidelines and have deferred this to the national competent authorities. This is understandable to a certain extent,

given the universe of products and their varying features that might fall into scope now or in the future as new retail investment products emerge over time across the different markets.

As establishing whether or not certain products fall within the scope of the Regulation is not straightforward, there has been a concerted effort, lead by industry associations, for clarification from the ESAs on precisely which products are in/out of scope. In response to these requests, some clarification has been forthcoming, notably in relation to derivatives transactions.

All derivatives in scope

For some months, there was considerable debate as to whether all derivatives, including those used for hedging purposes are within scope. The RTS seemed to point to this which caused some surprise amongst stakeholders not least because one of the key elements of the PRIIP definition is that the product is an 'investment'. Since the purpose of hedging derivatives is to reduce risk rather than to offer an investment opportunity, on the face of the Regulation it seemed that hedging derivatives were out of scope. This seemed to be supported by the fact that the use of a KID for derivative hedging products is likely to be uninformative, precisely because they are purchased as risk management tools and not as investments.

The issue was raised with the Commission who confirmed that, as there is no 'purpose test' in the Regulation, *all* derivatives are in scope, so it is irrelevant whether a product is intended for investment, risk management or hedging purposes. However, despite this confirmation, questions remain, most notably in relation to FX Forwards in deliverable currencies, as well as derivatives with similar characteristics with no 'fluctuation'. The industry awaits further clarification on these issues.

What is a PRIIP?

OTC derivatives

There are a number of practical consequences of all derivatives being in scope as, if a product is a PRIIP which is made available to retail investors, a KID must be produced. One of the most fundamental questions is how to produce a KID for hedging derivatives since, typically, not all of the information that must be shown in the KID is available at the point of sale, which is when the KID is to be made available to the investor. For example, the hedge in respect of a particular product might only be put in place at a relatively late stage, once the manufacturer knows how much of a product has been sold. At the launch date, when the product is sold and a KID is required, the manufacturer will not know the cost of the hedge, so it is not clear how these costs can be incorporated into the KID costs disclosure.

Although at first glance this may seem academic on the basis that it is unlikely that hedging products will be sold to retail investors, for these purposes 'retail investors' are defined by reference to MiFID2 and include small corporates, public sector bodies, local public authorities and municipalities. The fact, of course, that commercial companies and local authorities extensively use hedging derivatives exacerbates the issue.

A practical solution to the timing problem put forward by the industry is to use a generic KID for certain OTC derivatives (e.g. for FX options). There is a precedent for treating certain derivatives as a 'special case' as the RTS provide a derogation from the standard KID requirements for exchange traded derivatives. It was suggested during the workshop that standardised KIDs will be permissible, although it is not clear what level of standardisation will be accepted. It seems that trade specific details will not be required and indicative pricing can be used, however it is not clear how either the existing requirements or the proposed standardised requirements would be applied in practice, particularly given the overarching requirement that the KID is comprehensible, accurate and not misleading, a challenge that is further compounded by the mandatory 3 page length of the KID.

Key questions

- Which products are in scope?
- For PRIIPs that are sold cross border, who is the relevant competent authority since there is no host member state concept?
- For KIDs for certain OTC derivatives what information should be provided and how should it be presented?
- Who is the manufacturer?

Clearly, further guidance on how a KID should be produced for derivatives products is needed. The Commission has assured the market that it will co-operate closely with the ESAs to ensure that guidance is provided 'as soon as possible'. This is expected in the summer of 2016 and is expected to relate to the technical methodologies included in the PRIIPs RTS on risk, rewards and cost disclosure requirements.

Exchange-traded derivatives

The RTS recognise certain exchange traded derivatives as a special case, by permitting generic presentation requirements for these products, given their fast changing risk and performance characteristics. For example, performance scenarios at recommended holding periods are shown in the form of pay-off structure graphs; for all other PRIIPs, detailed calculations and simulations are required. Revision and re-publication is required at least every 12 months where there is a change that significantly affects, or is likely to significantly affect, the information in the KID. The corollary of this is that, for exchange-traded derivatives, KIDs would have to be updated on a continuous real-time basis. Therefore, for an exchange-traded derivative such as a standardised future, call or put, the RTS confirm that it is not necessary to continuously update the KID, as the information required for these instruments on their risks, rewards and costs does not fluctuate.

That said, considerable challenges remain, particularly for market operators, since under the regime the exchange is the manufacturer (or co-manufacturer). It is unlikely that exchanges, in their role as 'product manufacturers', will be willing (or have the capability) to prepare KIDs, and there is therefore a risk that exchange-traded derivatives could become inaccessible to retail investors.

Multiple option products (MOPs)

MOPs are also given special treatment in the RTS because a KID cannot be provided in the same format for PRIIPs that offer many underlying investment options, as each underlying investment option will have a specific risk, performance and cost profile. Consequently, the necessary information cannot be provided in a single, concise and stand-alone document.

Therefore for MOPs, manufacturers may choose one of two different approaches:

- a separate KID is produced for each option, containing general information about the PRIIP and specific information about the option
- a single, generic KID is produced, providing information on the PRIIP and specific information is provided in a supplemental document explaining details of the options (including information on their description, risks and rewards, and their specific costs). It should be noted that the information provided under this second approach must comply with the requirements set out in Article 8(3) of the Regulation, which specifies the contents of the KID.

However, the RTS clarify that there is no requirement to reflect every possible combination of the underlying investment options – so for example, of the particular combination of funds chosen to invest in under a life insurance policy. Such details of specific combinations of underlying investment options is not required because the KID is intended to assist the retail investor in considering and comparing options before they have made an investment decision and not in illustrating the investment decision they have already made.

Plain vanilla bonds

Market consensus and recent commentary from the Commission and the ESAs suggests that fixed and floating rate notes

"Confirmation from the Commission that only PRIIPs sold to EU retail investors are in scope is welcomed."

are out of scope. However, the position in respect of notes with features such as puts/calls, caps, collars and certain conversion features remains unclear.

Territorial scope

Under the Level 1 text, the territorial impact of the Regulation is unclear. It has subsequently been confirmed that the requirements apply whenever a PRIIP is sold by an entity to an EU retail investor '(retail investors' are defined by reference to MiFID2); a KID is not required where the retail investors are situated outside of the EU. It was reiterated during the workshop that the domicile of the retail investor is not a determining factor and the trigger is whether the retail investor is in the EU.

It should be noted that, although the Regulation is an adopted EU legal act marked as EEA relevant by the EU, it is currently under scrutiny for incorporation into the EEA agreement by Iceland, Lichtenstein and Norway. This relates to the ongoing issue in respect of the incorporation of the regulations establishing the three ESAs which have not yet been adopted by the EEA Joint Committee. Consequently, it is not yet certain when the Regulation will apply to the EEA.

Grandfathering and secondary market trading

'Grandfathering' of existing trades

There are no grandfathering provisions in the Regulation, and the Commission has confirmed that this means that PRIIPs 'offered to retail investors' as at the date of application of the Regulation require a KID, regardless of whether they are new or existing products.

This has caused concern in the industry due to the significant costs involved for manufacturers in complying with the Regulation in relation to pre-existing products, particularly because the costs would not have been taken into account when pricing the product.

In addition to concerns about costs, implementation plans will be significantly impacted. More time will be needed to implement the Regulation, as further changes to internal systems and procedures will be required.

The Commission has indicated that it is 'aware of the challenges and complexity' surrounding existing products and will provide additional clarity. However, aside from indicating that a 'practical approach' will be adopted, no further guidance has been forthcoming, so this remains an area of uncertainty.

Secondary market trading

There is uncertainty around whether the Regulation applies to secondary market trading. It is clear that manufacturers must produce a KID for a PRIIP that is 'made available to retail investors', but it is unclear what this means in practice: should a PRIIP traded on a secondary market *automatically* be regarded as being 'made available to retail investors' and therefore trigger the requirement to provide a KID?

Many in the industry argue that the Regulation should not *automatically* apply to secondary market trading, and should instead be triggered only where a PRIIP is *actually* bought or sold on a secondary market, on the basis of firm two-way pricing from the manufacturer (acting as a market maker) on an exchange.

Despite calls for clarification, concerns around secondary market trading remain and could pose significant consequences for market liquidity: an originator of a PRIIP may stop making a two-way market for existing products and limit activity to 'bid-only' transactions, so that manufacturers are effectively buying back PRIIPs, in order to avoid the burden of producing a KID.

Light at the end of the PRIIPs tunnel?

Following the workshop, although the position is reserved, some clarity was forthcoming:

- For listed products with a bid only price, no KID is required.
- There is no obligation to provide a KID if a PRIIP is offered to professional investors.
- There is no obligation to provide a KID in the case of discretionary mandates, therefore for PRIIPs bought and sold by portfolio managers, including in the name and for the account of a retail client, no KID is required.
- In respect of territoriality, KIDs offered to retail investors outside of the EU are not in scope.

Discretionary investment managers

The application of the Regulation to the situation where there is a discretionary investment manager has caused some confusion. Since a KID is intended to inform a decision to purchase an investment, it clearly performs no useful function – and should not be required – where the investment decision is taken by a professional investment manager acting with discretion. During the workshop it was confirmed that a KID is not required when a professional investor has a discretionary mandate and acts in the name of and for the account of a retail investor.

It is not entirely clear what the position is where an investor is acting on the basis of investment advice received from a professional investment adviser. In this situation it is arguable that the KID should still be provided to the investor, since it is he or she who ultimately makes the decision. It seems likely that this is the situation which Article 13(2) of the Regulation is intended to address. This article provides an alternative route to the normal KID distribution requirement, so that 'the requirement to provide the retail investor with a KID may be satisfied by providing the KID to a person with written authority to make investment decisions on behalf of the retail investor in respect of transactions concluded under that authority'. On the face of it this Article is a nonsense, since it provides a mechanism for delivery of a KID in circumstances where a KID is not required. However, it is possible to envisage circumstances in which it might apply – for example where a manufacturer deals with an investor through an intermediary, but the specific sale concerned is not executed within the intermediary's discretionary mandate. As a result the manufacturer, although dealing with the intermediary, is subject to an obligation to deliver a KID to an investor. In this case, the effect of Art 13(2) is that the manufacturer can discharge any such obligation by delivering the KID to the intermediary. This could be useful where the intermediary is not prepared to identify the specific investors for whom he is acting to the manufacturer, but is prepared to demonstrate that he is acting on their written authority.

Interestingly, following the workshop, certain European associations have written to the Commission, the European Parliament and the Council noting that the proposal to address some of these outstanding issues in Level 3 measures such as Q&A will not provide the necessary certainty and the relevant issues should be addressed in the RTS. To the extent that the consequence of the confirmation in respect of discretionary

mandates is that the requirements in Article 13(2) do not apply, this should be formerly clarified by way of amendment to the Level 1 Regulation.

Implementation challenges

The RTS are likely to be published in the Official Journal in the fourth quarter of 2016. This will give product manufacturers and distributors around 3 months to meet the 31 December 2016 implementation date.

Given the significant number of outstanding issues that need to be resolved prior to implementation it is hoped the Level 3 guidance will be published promptly and will provide sufficiently clarity on the issues that have been raised by stakeholders.

Despite these challenges and the hurdles that remain, the market has been working hard to prepare for implementation of the Regulation, largely due to the scale of systems and technological changes necessary to implement the regime, such as the development and testing of automation tools for product manufacturers.

Possible delay in implementation?

Concerns about meeting the December 2016 deadline have led industry representatives to seek a delay in implementation. They have pointed to the one year delay in the implementation of MiFID2 and have argued that the factors listed by the Commission in explaining the need for that delay – complexity and the need to avoid legal uncertainty and market disruption – are the same reasons that justify a delay in the implementation date for the PRIIPs regime.

However as yet there is no indication that the European authorities are willing to delay the implementation of PRIIPs, so the industry must assume that the Regulation will apply from 31 December 2016.

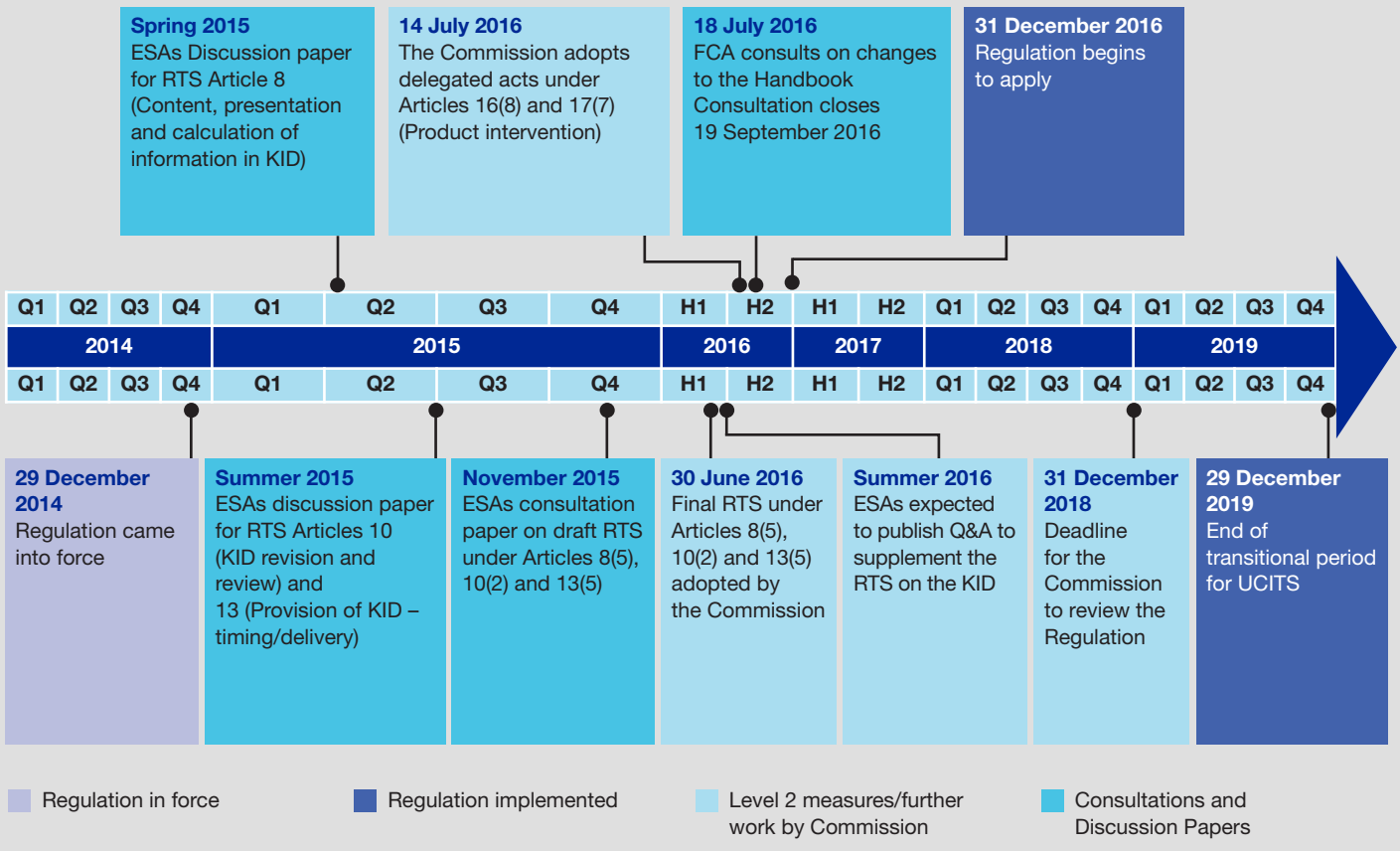
Next steps in the European process

Level 2 measures

On 30 June 2016, the Commission adopted RTS specifying the exact contents of the KID, including the risks, rewards and costs of the product.

The next step is for the RTS to be approved by the European Parliament and

PRIIPs Timeline



the Council of the EU. They usually have a two month period in which to object to the RTS, which they may extend for a further month, and there is a possibility that this may happen, as on 11 July 2016 COREPER was invited to ask the Council to extend the objection period until 30 September 2016, although this extension has not yet been confirmed.

Once approved, the RTS will enter into force on the twentieth day after publication in the Official Journal and will apply from 31 December 2016.

Additionally, the Commission adopted the Delegated Regulation regarding product intervention on 14 July 2016, which is now being considered by the Parliament and the Council. If neither of them objects, it will enter into force 20 days after it is published in the Official Journal and will also apply from 31 December 2016.

Level 3 guidance

The Commission and the ESAs are focused on developing guidance to aid implementation and supervision by the national competent authorities. It is likely that the European Commission will publish at the end of this month guidance on the key questions such as scope, territoriality and the meaning of "made available". The ESAs are in the process of finalising Q&As that will address in the main, the technical requirements in the RTS on risks, rewards and costs disclosures however it is unclear when these will published since the RTS are still under scrutiny by the European Parliament and the Council. Given the request that the objection period be extended to the end of September 2016, the ESAs may need to consider alternatives for signalling their responses.

UK implementation

The Financial Conduct Authority (FCA) issued a consultation paper on 18 July 2016 on amendments to disclosure requirements in the FCA Handbook to reflect the introduction of the Regulation. Although UK legislation is not required to transpose directly effective provisions in an EU Regulation, the UK must still make sure that the domestic law is compatible with EU Regulations and, if necessary, amend existing law. The FCA will therefore need to review the provisions of the FCA Handbook to ensure compliance with the Regulation and to ensure that the UK does not have any domestic rules that overlap or conflict with the Regulation. The disclosure requirements in the Conduct of Business chapter of the FCA Handbook will therefore need to be re-evaluated. Where certain disclosure requirements are required by other European directives these will remain, however it is likely that the key facts document requirements will be cut back to apply to those selling products which are not caught by the Regulation.

The consultation period ends on 19 September 2016.

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