FCA PROPOSES FURTHER DIVERGENCE FROM THE EU PRIIPS REGULATION

On 20 July 2021, the FCA published a **consultation paper** proposing further amendments to the UK PRIIPs regime. The proposed changes aim to: (i) clarify the products in respect of which a KID should be produced; and (ii) improve the information that is provided within the KID. In particular, the changes seek to address long-held industry concerns that the performance scenarios, risk indicators and transaction costs that must be provided within the KID are potentially misleading to investors. The proposals evidence both the FCA's continued focus on consumers and its willingness to diverge from EU requirements where it considers that this would be beneficial to such consumers.

Background

Regulation (EU) no. 1286/2014 on key information documents for packaged retail and insurance-based investment products (the "**EU PRIIPs Regulation**") came into force on 1 January 2018. It aimed to improve the information provided to retail investors in packaged products ("**PRIIPs**"), such as investment funds, derivatives and structured deposits.

The key obligation introduced by the EU PRIIPs Regulation was for those who produce, advise on or sell PRIIPs to provide a short, easily-understandable key information document ("**KID**") to retail investors in those products. The content and form of the KID must comply with detailed, prescriptive requirements.

For some time, there have been concerns that the prescriptive requirements for the content of the KID may result in the provision of misleading information to investors. Following Brexit, the UK has onshored the EU PRIIPs Regulation into the UK (the "**UK PRIIPs Regime**"), the result of which is that the UK is able to amend the UK PRIIPs Regime to address its concerns.

Key takeaways

- The FCA has published a consultation paper proposing amendments to the UK's PRIIPs regime.
- With regards to the scope of the UK PRIIPs regime, the amendments seek to: clarify the application of the UK PRIIPs regime to corporate bonds; confirm that the regime does not apply to instruments issued before 1 January 2018; and provide guidance on whether a PRIIP has been 'made available' to a retail investor in the UK.
- In addition, the proposals seek to address concerns that the current information on performance, risk and transaction costs that must be included within the KID may be misleading.
- Comments on the consultation may be submitted to the FCA until 30 September 2021. The FCA plans to make its final rules by the end of 2021, with the revised rules coming into effect on 1 January 2022.
- The proposals represent the FCA's first step towards improving investment disclosures for consumers in advance of HMT's planned wider review of the disclosure regime for UK retail investors.

The FCA's proposals

The FCA's consultation paper, entitled "PRIIPs – Proposed scope rules and amendments to Regulatory Technical Standards" ("**CP21/23**"), seeks to address concerns that were raised by respondents to the FCA's 2018 'Call for Input' on the EU PRIIPS Regulation and associated technical standards (the "**EU PRIIPS Regime**").

The proposals fall into three categories:

1. Scope of the UK PRIIPs regime

The FCA proposes to:

- clarify the application of the UK PRIIPs Regime to debt securities;
- confirm that the UK PRIIPs Regime does not apply to financial instruments issued prior to 1 January 2018; and
- provide guidance to clarify whether a PRIIP should be considered to have been 'made available' to retail investors in the UK.

2. Information on performance and risk that must be included within the KID

The FCA proposes to:

- remove the requirement for PRIIPs manufacturers to display performance scenarios in KIDs, replacing this with a requirement for PRIIPs manufacturers to include a narrative description within the KID of the factors that are likely to affect future performance.
- address concerns that certain PRIIPs, such as venture capital trusts, are given inappropriate risk scores. Proposals in this area include a requirement for PRIIPs manufacturers to upgrade their products' scenario risk analysis if they consider that the risk rating produced is too low and a proposed minimum risk score for venture capital trusts.

3. Transaction costs disclosure requirements

The FCA proposes to address concerns regarding misleading transaction costs disclosures in relation to debt securities, index-tracking funds and funds that use anti-dilution measures.

The table in Annex 1 sets out in greater detail the FCA's key proposals and the concern that each proposal is intended to address.

Application of the proposals

The proposals would apply to firms that manufacture and market PRIIPs into the UK. This includes EU, EEA and other non-UK manufacturers and distributors that manufacture and market PRIIPs into the UK.

Divergence from the EU PRIIPs regulation

The proposals do not represent the first divergence between the UK and EU PRIIPs Regimes. The onshoring of the EU PRIIPs Regulation into the UK resulted in minor divergences between the EU and UK PRIIPs Regimes. In addition, in June 2021 HM Treasury confirmed that it intends to extend the current UCITS exemption (under which UCITS are exempt from the requirement to produce a KID) by a further 5 years, such that it lasts until 31 December 2026. Whilst an extension of the UCITS exemption is also expected within the EU, it is expected to be shorter.

Looking to the future, in June 2020 the UK government announced that it intends to conduct a wholesale review of the disclosure regime for UK retail investors. In January 2021 the European Commission similarly announced that it intends to undertake a broad review of the EU PRIIPs Regulation. As a result, it appears that greater divergence between the UK and EU PRIIPs Regimes is likely.

Next steps

The deadline for submitting comments on CP21/23 is 30 September 2021. Comments may be submitted on the FCA's website or by email to **CP21-23@fca.org.uk**.

The FCA plans to make its final rules by the end of 2021, with the revised rules coming into effect on 1 January 2022. As a result, firms will have only a short period in which to implement the proposals and should begin to consider their implementation plans as soon as possible.

Annex 1

Summary of concerns and the FCA's proposed remedies

The following table sets out the FCA's key proposals in CP21/23 and the concern that each proposal is intended to address.

Concern	Proposal in CP21/23
1. Scope of the UK PRIIPS regime	
• Lack of clarity over the application of PRIIPs requirements to products that were issued before 1 January 2018 but that are still available for trading on secondary markets.	• The FCA proposes to introduce a new rule into the FCA Handbook to confirm that a financial instrument issued prior to 1 January 2018 is not a PRIIP (and, as such, not subject to the UK PRIIPs Regime).
• Lack of clarity over the application of PRIIPs requirements to corporate bonds.	• The FCA proposes to introduce new rules stating that: – debt securities are not PRIIPs if they meet certain criteria (notably, that the issuer's default risk is wholly or predominantly determined by the economic performance of the commercial or industrial activities of the issuer; and the terms of the debt security do not impose any modification, structuring or conditionality on the issuer's obligation to pay interest or repay the principal); – debt securities are PRIIPs if they meet certain criteria (such as if the interest payable is linked to fluctuations in stock market indices); and – certain features (such as certain fixed coupon rates, variable coupons and put options) do not cause a debt security to be a PRIIP.
• Lack of clarity over when a PRIIP is 'made available' to retail investors in the UK.	• The obligation to provide a KID applies where a PRIIP is 'made available' to retail investors in the UK. The FCA proposes to introduce guidance stating that a financial instrument should not be considered to be 'made available' if certain conditions are met. The conditions are, in summary, that: – the marketing materials disclose that the financial instrument is only offered to professional clients and eligible counterparties and is not intended for retail investors; – the issuer or distributor of the financial instrument takes reasonable steps to ensure that the offer and marketing are directed only to professional clients and eligible counterparties; and – a denomination or minimum investment of £100,000 (or non-sterling equivalent) applies to the financial instrument.

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<table>
<tr><th colspan="2">2. Information on performance and risk</th></tr>
<tr><td>The methodology for calculation and presentation of performance scenarios within the KID can produce misleading illustrations.</td><td>The FCA proposes to remove the requirement for PRIIPs manufacturers to display performance scenarios in the KID and to instead require PRIIPs manufacturers to describe, in narrative form, the factors likely to affect future performance.</td></tr>
<tr><td>The 'Summary Risk Indicator' included within the KID delivers lower risk ratings than expected when the PRIIPs' underlying or reference asset is illiquid.</td><td>The PRIIPs regime requires the KID to contain a standardised risk score of between 1 and 7, calculated in accordance with a mandatory methodology. The FCA proposes to require:
PRIIPs manufacturers to upgrade their products' Summary Risk Indicators if they consider that the risk rating produced by the methodology is too low.
PRIIPs issued by Venture Capital Trusts to be assigned a Summary Risk Indicator score of no less than 6.
PRIIPs manufacturers to notify the FCA if they upgrade their products' Summary Risk Indicator score.
In addition, the current 200-character limit within which PRIIPs manufacturers are allowed to explain significant risks that are not covered in the Summary Risk Indicator calculations would be raised to 400 characters.</td></tr>
<tr><th colspan="2">3. Transaction costs disclosure requirements</th></tr>
<tr><td>Funds that use anti-dilution may find that the benefit to the fund from anti-dilution is more than the transaction costs that it has incurred over the same period, leading to the reporting of negative transaction costs in the KID.</td><td>The FCA proposes to require:
firms using an anti-dilution mechanism to disclose anti-dilution benefits in the KID; and
that the anti-dilution benefit must not be considered, if and to the extent that the benefit would take the total transaction costs below zero.</td></tr>
<tr><td>Calculation of transaction costs for OTC bond transactions.</td><td>The FCA proposes that firms should use the average of the best bid and best offer obtained when seeking quotes from multiple counterparties.</td></tr>
<tr><td>Calculation of transaction costs for index-tracking funds.</td><td>The FCA proposes that index-tracking funds should use a spread model to calculate costs. When calculating the costs associated with orders that are initially entered into an auction, the arrival price should be calculated as the mid-price immediately prior to the auction. When calculating costs associated with orders that are executed at a predetermined time, the arrival price should be calculated at that pre-determined time even if the order is transmitted for execution before that time.</td></tr>
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