

# Structured Thoughts

*News for the financial services community.*



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## No More KIDding Around: European Parliament Approves PRIIPs Regulation

### Introduction

Almost two years after the European Commission published its draft Regulation (the "Regulation") relating to packaged retail investment products ("PRIIPs"), the European Parliament finally approved, with amendments, the Commission's proposal on 15 April 2014<sup>1</sup>. The Regulation is expected to be adopted by the Council into law in the summer of this year, and will apply two years after it comes into force. As an EU Regulation, it will be directly and uniformly applicable in all Member States, and will have a substantial impact on the documentation used in offerings of structured products to retail investors in the EU.

The Regulation essentially introduces a new pan-European pre-contractual product disclosure regime for packaged investment products. The principal aim of the Regulation is to ensure that retail investors are able to understand and compare the key features of different packaged investment products, regardless of their legal form. It does this by

<sup>1</sup> The text of the Regulation as approved by the European Parliament may be found at: <http://www.europarl.europa.eu/sides/getDoc.do?type=AMD&reference=A7-2013-0368&format=PDF&language=EN&secondRef=004-004>, the accompanying press release from the European Parliament at: <http://www.europarl.europa.eu/news/en/news-room/content/20140411IPR43440/html/Key-things-small-investors-should-be-told> and the corresponding Commission statement at: [http://europa.eu/rapid/press-release\\_STATEMENT-14-122\\_en.htm?locale=en](http://europa.eu/rapid/press-release_STATEMENT-14-122_en.htm?locale=en).

obliging product manufacturers and distributors respectively to produce and provide to retail investors key information documents ("KIDs") for certain packaged investment products.

The Regulation forms an important part of the Commission's wider package of proposals on the regulation of PRIIPs. The Regulation complements the investor protection measures on investment advice and sales services that are being extended to apply to all products covered by the Regulation under MiFID II and IMD2<sup>2</sup>. The European Supervisory Authorities ("ESAs"), consisting of the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority, will develop draft regulatory technical standards to provide further detail in respect of certain aspects of the Regulation, as discussed below.

## Key Provisions

### Scope

The Regulation applies to packaged retail *and insurance-based* investment products ("PRIIPs") that are sold to retail investors, which are not being invested in directly. The definition of an investment product remains essentially the same as in the Commission's proposal, which is basically any instrument whose return fluctuates by reference to the value or performance of other assets. In addition, instruments issued by special purpose vehicles are now also included. An insurance-based investment product is defined as an insurance product which offers a maturity or surrender value that may be affected by market fluctuations.

As a result, the definition of PRIIPs covers all investment funds (including UCITS funds), all structured products (whether packaged as insurance policies, funds, securities, bank deposits, or otherwise), and any derivative, subject in each case to certain express exclusions from the scope of the Regulation:

- non-life insurance products, or life insurance products where the benefit is payable only on death or in respect of incapacity due to injury, sickness or infirmity, as any surrender value of those products will not be exposed to market fluctuations;
- non-structured deposits;
- "vanilla" securities that do not contain an embedded derivative. Any securities exchangeable or convertible into shares or other securities will not fall within this exclusion;
- pension products which provide an investor with an income in retirement and entitle the investor to certain benefits, and occupational pension schemes covered by the Occupational Pensions Funds Directive or the Solvency II Directive; and
- pension products for which a financial contribution from the employer is required by national law and where the employee has no choice as to the pension product provider.

### Interaction with the Prospectus Directive and the UCITS IV Directive

The Regulation states that its requirements run in parallel with those of the Prospectus Directive<sup>3</sup> and the UCITS IV Directive<sup>4</sup>. In relation to the UCITS IV Directive, UCITS management companies, investment companies and persons selling units of UCITS will be exempt from complying with the Regulation for a period of five years after the Regulation comes into force, subject to a review by the Commission after four years to decide whether to continue those transitional arrangements or whether to align the key investor documents under the UCITS IV Directive and the Regulation. For the Prospectus Directive ("PD"), there is no such exemption; as a result, issuers of structured securities issued to retail investors under a PD-compliant prospectus will therefore have to ensure that both a KID and an issuance-specific summary (required by the PD) is produced. As we have previously stated, this seems to run counter to the objective of

<sup>2</sup> MiFID II and IMD2 refer to the proposed reform and recasting of the Markets in Financial Instruments Directive, the new Markets in Financial Instruments Regulation, and the Investment Management Directive, respectively.

<sup>3</sup> Directive 2003/71/EC: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:345:0064:0089:EN:PDF>.

<sup>4</sup> Directive 2009/138/EC: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF>.

providing a more level playing field between different types of products. It also seems unnecessarily confusing that investors will receive two different types of summaries, which are both intended to set out key features and risks of the product.

#### *Format and Content of KID*

The KID must be a maximum of three sides of A4 paper in length and must be accurate, fair, clear and not misleading. In order to promote comparability and comprehension by investors, the KID should not contain any unnecessary information beyond that which is specified in the Regulation. The KID must be a stand-alone document, in that investors should not be required to read other documents to be able to understand the key features of the investment product. However, there are two exceptions to this: (i) it may cross-reference other documents, such as a prospectus, but only where the cross-reference is to information required to be included in the KID; and (ii) where a PRIIP offers a range of investment options, the KID must provide a generic description of the underlying investment and state where and how more detailed pre-contractual information can be found. Further, the KID must be reviewed on a regular basis by the product manufacturer, in order to ensure that it is up-to-date and remains compliant with the Regulation. Further details, both as to the format and content of the KID (particularly in relation to the details of the risk / reward profile and the calculation of costs associated with the PRIIP) and the review of the KID, will be provided in draft regulatory technical standards from the ESAs, which will take into account the different types and natures of PRIIPs and the different capabilities of retail investors to comprehend their features.

The Regulation contains considerable prescriptive requirements as to the form of the KID. It must have the title “Key Information Document” at the top of the first page, together with an explanatory statement which must follow the language set out in the Regulation. The KID must also include the following sections in the sequence set out in Article 8 of the Regulation:

- The name of the investment product, and the identity, contact details and competent authority of the product manufacturer
- A “comprehension alert”, where applicable, stating: “You are about to purchase a product that is not simple and may be difficult to understand”
- A section titled “What is this product?” setting out the nature and features of the investment, including the type of product, its objectives and the means for achieving them (in particular whether those objectives are achieved through direct or indirect exposure to underlying assets, a description of those underlying assets and any specific environmental and social objectives of the product (if applicable), the target consumer and the term of the product (if known)
- A section titled “What are the risks and what could I get in return?” setting out the risk and reward profile of the product, including: (i) a summary risk indicator of this profile, supplemented by a narrative explanation of this indicator, its limitations and specific risks not reflected in that indicator (this supplemental requirement was probably introduced due to concerns that a summary indicator would give an oversimplified measure of risk for a complex product and give rise to a risk of over-reliance on the indicator by investors); (ii) the possible maximum loss of invested capital, including whether the investor may lose all his capital and whether there are any additional financial obligations or commitments for the investor; (iii) appropriate performance scenarios and the assumptions underpinning them; and (iv) a statement that the tax legislation of the investor’s home Member State may have an impact on the return
- A section titled “What happens if the [name of PRIIP manufacturer] is unable to pay out?” setting out whether the product is covered by an investor protection or guarantee scheme and the terms and limitations of that scheme
- A section titled “What are the costs?” setting out the costs associated with an investment in the product (both direct and indirect), summary indicators of these costs and, to ensure comparability, total aggregate costs (including costs of distribution) in both monetary and percentage terms

- A section titled “How long should I hold it and can I take money out early?” setting out whether there is a cooling off period for the PRIIP and any recommended or minimum holding period, including whether the PRIIP can be redeemed prior to maturity and the potential consequences of cashing in before the end of the term or recommended holding period, including any fees, penalties or loss of capital guarantee
- A section titled “Other relevant information” indicating any additional documents to be provided to the investor by the manufacturer at pre- or post-contractual stage, excluding any marketing material

#### *Responsibility for Producing the KID and Providing It to Investors*

The product manufacturer is responsible for producing the KID. The product manufacturer is defined as the person who (i) manufactures an investment product or (ii) makes changes to an existing investment product that alter key features of the product, such as its risk/reward profile or its associated costs.

The distributor (i.e., the person advising on or selling the PRIIP) must provide the KID to the retail investor, or to a person with written authority to make investment decisions on behalf of that investor, free of charge and “in good time” before the purchase. There is a limited exception for “distance-selling”, which occurs if:

- a) a retail investor has chosen, on his own initiative, to contact the seller and conclude the transaction by means of distance communication;
- b) prior distribution of the KID was not possible;
- c) the distributor has informed the investor of (b) and clearly stated that the retail investor may delay the transaction to receive the KID before concluding the sale; and
- d) the investor has chosen to receive the KID “without undue delay” after the transaction.

The KID must be produced on paper (which is the default medium for a KID where there is a face-to-face communication, unless the investor requests otherwise) or another durable medium, or by way of website, in a way that meets the conditions specified in the Regulation, including that the investor has consented to the provision of the KID by website and has been notified electronically of where to access the document on the web. The ESAs will provide further guidance, through draft regulatory technical standards, in relation to the distributors’ obligations to provide the KID to retail investors.

#### *Liability for Failure to Comply with Regulation, Sanctions and Intervention Powers*

Under the Regulation, if a KID is misleading, inaccurate or inconsistent with the relevant parts of legally binding pre-contractual and contractual documents or with the KID content requirements set out in Article 8, a PRIIP manufacturer may be subject to civil liability. Retail investors will be entitled to claim damages if they can demonstrate a loss arising from reliance on the KID. There is no longer the concept of a “reverse burden of proof,” which was included in the Commission’s proposal, whereby the product manufacturer would be liable unless it could show that the KID complied with the content requirements of the Regulation.

The Regulation leaves it to the competent authorities of Member States to provide for appropriate administrative sanctions that are “effective, proportionate and dissuasive” for breaches of the Regulation, and to coordinate with each other to ensure that those sanctions avoid duplication and overlap in relation to cross-border cases. The sanctions include the prohibition or suspension of the marketing of the relevant PRIIP, prohibition of the provision of a non-compliant KID, pecuniary sanctions and public disclosure of any administrative sanctions imposed (subject to exemptions where, for example, such disclosure would not be proportionate or would jeopardise the stability of the financial markets). The Regulation also obliges Member States to establish effective whistleblowing regimes to enable actual or potential breaches of the Regulation to be reported to competent authorities.

The Regulation only provides for product intervention powers for EIOPA and competent authorities in relation to insurance-based products. These powers for other PRIIPs may be found in other legislation, such as MiFID II.

*Territorial Scope, Including Impact on U.S. Registered Offerings*

The preamble to the Regulation makes it clear that one of the main purposes of the Regulation is to create an even level of investor protection within the EU, in order to assist the smooth functioning of the single market. Therefore, it would seem that all manufacturers and distributors of structured products and other PRIIPs will be subject to the obligation to produce a KID, if a PRIIP is sold to any retail investor in the EU, even if such product manufacturers and distributors are situated outside of the EU. This will include a situation where a registered offering of a structured product originates from the U.S., but is sold in part to EU retail investors.

The Regulation states that product manufacturers and distributors should establish appropriate procedures and arrangements which provide “effective redress procedures” for retail investors in relation to cross-border disputes, in particular where the product manufacturer is located in another Member State or a third country. As the Joint Associations Committee on Retail Structured Products (“JAC”)<sup>5</sup> has noted, this is not as clear as saying that the Regulation will apply to all product manufacturers and distributors, regardless of where they are located, as long as the PRIIP is sold to retail investors in the EU, and so it is hoped that level 2 regulation will clarify this provision.

It also seems that disclaimers for structured products contractually required by license agreements, as well as U.S. Regulation S and other securities laws legends, should not be included in the KID; under the Regulation, these types of disclosures do not constitute “key information” that is necessary to enable investors to understand a PRIIP. It is hoped that this will also be clarified, and perhaps liberalized, by level 2 regulation.

*Review*

The Regulation indicates that after four years of it coming into force, the Commission will undertake a comprehensive review into matters such as whether the UCITS IV Directive transitional arrangements should continue to apply (discussed above), whether to expand the scope of the Regulation to other products and remove some of the current product exemptions, the effectiveness of the comprehension label and whether there are effective online calculator tools that are available free-of-charge to allow retail investors to compute the aggregate costs and fees of PRIIPs (or whether such tools need to be developed).

**Conclusion**

The KID requirements are heavily prescriptive and likely to be even more so once implementing legislation is published. Although there are clear advantages to having descriptions of products aimed at retail investors set out in a consistent way, an overly-prescriptive approach could increase administrative costs to the detriment of investors, without necessarily aiding comparability across different sectors. Further, as the JAC has emphasised, a KID *alone* cannot provide the basis of an informed investment decision – a KID should *assist* retail investors in understanding the nature, risks and rewards of the investment product and help them to compare it against other investment products. Therefore, retail investors should be encouraged to read KIDs in conjunction with the rest of the information they receive, in order to make a fully informed decision, as three A4 sides of information is unlikely to be enough to tell them all they need to know.

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## **FINRA Amends Rule 5110 to Exempt Certain Collective Investment Vehicles from Its Filing Requirements**

On May 15, 2014, amendments to FINRA Rule 5110 became effective.<sup>6</sup> Among other items,<sup>7</sup> the changes expand the exemption from the filing requirements of the rule for exchange-traded funds (ETFs). Rule 5110(b)(8) (Exempt Offerings) provided and continues to provide an exemption for investment companies from the rule's filing requirements. This covers

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<sup>5</sup>The JAC is sponsored by multiple associations with an interest in structured products.

<sup>6</sup>The text of the amended rule may be found at the following link: [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=6831](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6831).

<sup>7</sup>For further discussion of the amendments to Rule 5110, please see our client alert at <http://www.mofo.com/~media/Files/ClientAlert/1410520SECAmendmentsFINRA.pdf>.

the securities of “open-end” investment companies as defined in Section 5(a)(1) of the Investment Company Act of 1940 (the “Investment Company Act”), as well as of “closed-end” investment companies as defined in Section 5(a)(2) thereof that offer their shares on a continuous basis and make periodic repurchase offers.<sup>8</sup> This exemption generally covers ETFs that are structured as investment companies.

FINRA, believing it appropriate to exempt certain other ETFs from the Rule 5110 filing requirements as well, amended Rule 5110(b)(7) (Offerings Exempt from Filing) by adding subparagraph Rule 5110(b)(7)(H), which exempts offerings of securities issued by a pooled investment vehicle that is not registered as an investment company under the Investment Company Act and has a class of equity securities listed for trading on a national securities exchange. Such equity securities must be creatable or redeemable at their net asset value per share on any business day. The pooled investment vehicle may be formed as a trust, partnership, corporation, limited liability company or other collective investment vehicle.

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## The Time for the SEC Action on FINRA’s Proposed Amendments to Communication Rules Extended to June 27, 2014

On April 23, 2014, FINRA extended the time for the SEC action on its proposed amendments to Rule 2210, the so-called communication rules, to June 27, 2014. Rule 2210, as amended, requires broker-dealers to file with FINRA “retail communications” concerning registered structured products. On March 10, 2014, FINRA filed with the SEC proposed amendments to Rule 2210, which are mainly to clarify that both prospectus and similar documents filed with the SEC and FWPs that are exempt from filing with the SEC are not subject to FINRA’s filing requirements or content standards.<sup>9</sup> If the SEC approves the proposals, currently by June 27, 2014, FINRA will announce the effective date in a Regulatory Notice published within 60 days of the approval. The effective date will be within 30 days after that notice.

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## 3rd Annual North American Structured Products Conference

Morrison & Foerster is sponsoring *StructuredRetailProducts.com*’s 3rd Annual North American Structured Products Conference. The conference will bring together senior representatives from retail banks, insurance companies, investment banks, fund managers, law firms, regulatory bodies and independent investment advisers to discuss the structured products industry.

Morrison & Foerster will host a 90-minute “Legal & Regulatory Boot Camp” that will cover:

### Topics Will Include:

- Know your distributor practices;
- Negotiating MSDAs;
- New product approval/index approval policies and procedures;
- Index governance and compliance concerns;
- FINRA communications rules; and

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<sup>8</sup> Pursuant to Rule 415(a)(1)(xi) under the Securities Act of 1933 and Rule 23c-3(b) under the Investment Company Act, respectively.

<sup>9</sup> For a discussion of FINRA’s proposed amendments to its communication rules, see Volume 5, Issue 3 of *Structured Thoughts* (April 9, 2014), available at <http://www.mofo.com/files/Uploads/Images/140409-Structured-Thoughts.pdf>.

- Distributor liability.

Presenters include Brad Berman, Anna Pinedo and Lloyd Harmetz.

Additionally, Morrison & Foerster tax partner Remmelt Reigersman will speak on a “Legal & Regulatory Roundtable.”

Anna Pinedo will moderate a “Roundtable: Q&A with Regulators.”

For more information about the conference, and to register, [click here](#).

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Morrison & Foerster named **Structured Products Firm of the Year, Americas, 2014** by *Structured Products* magazine for the sixth time in the last nine years. See the write-up at <http://www.mofo.com/files/Uploads/Images/120530-Americas-Awards.pdf>.

Morrison & Foerster named **Best Law Firm in the Americas, 2012, 2013** by *StructuredRetailProducts.com*.

Morrison & Foerster named **Legal Leader, 2013** by *mtn-i* at their Americas Awards. Two of our 2012 transactions were also granted awards of their own as a result of their innovation.

Morrison & Foerster named **European Law Firm of the Year, 2013** by *Derivatives Week* at their Global Derivatives Awards.

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