Structured Thoughts

News for the financial services community.

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Joint Report of the 3L3 Task Force on PRIPs

On 6 October 2010, a task force of the three Level 3 Committees, comprising the Committee of European Securities Regulators ("CESR"), the Committee of European Banking Supervisors ("CEBS") and the Committee of European Insurance and Occupational Pensions Supervisors ("CEIOPS"), published a joint report (the "Report") on packaged retail investment products ("PRIPs").[1]

The task force was established following the announcement by the European Commission (the "Commission") in April 2009 of its initiative on packaged retail investment products ("PRIPs"), in order to assist the Commission's ongoing work on this policy area as it formulates the legislative proposals.[2]

In a covering letter to the Commission,[3] the Committees explained that they had sought to form consensual views, but that not all parts of the Report were consensual. Alternative positions have been expressed where a consensus has not been possible and further discussion among the task force members is required.

The Report focused on three key aspects of PRIPs: (i) the scope of the PRIPs regime; (ii) the product disclosure requirements for PRIPs; and (iii) the regulation of their selling practices.

We summarise below the main comments and suggestions of the task force contained in the Report.

[1] Report of the 3L3 Task Force on PRIPs (6 October 2010), http://www.cesr.eu/popup2.php?id=7278.
[2] *See* Morrison & Foerster client alert: An update on the EU actions on PRIPs (10 February 2010), http://www.mofo.com/files/Publication/f17b0cf1-4d0f-469a-955d-e48fe44565bd/Presentation/PublicationAttachment/a7aa0212-967d-4490-940d-ff237efc43b8/100210Structured_thoughts_issue_3.pdf.
[3] 3L3 covering letter to European Commission submitting the report on PRIPs (6 October 2010), http://www.cesr.eu/popup2.php?id=7277.

Scope

Throughout the consultation process in relation to PRIPs, a key issue has been identifying a suitable definition. The task force further considered the three key features of PRIPs previously outlined by the Commission, being (i) an element of packaging, which exposes consumers to the performance of assets or other financial measures indirectly; (ii) a product capable of meeting an investor's need for capital accumulation; and (iii) a product that creates exposure to investment risk for the investor.[4]

The task force proposed the following legal definition for PRIPs: *"A PRIP is a product where the amount payable to the investor is exposed to (a) fluctuation in the market value of assets or (b) payouts from assets, through a combination or wrapping of those assets, or other mechanisms than a direct holding."* A minority of task force members regarded this definition to be too broad and suggested rephrasing to reflect the level of investment risk (e.g., preferring "substantially exposed" to "exposed") and the principle of proportionality (e.g., objecting to "payouts from assets", as it would capture some life insurance products not generally regarded as structured products).

Although many market participants, including the Joint Associations Committee, have previously petitioned that the definition should focus only on products marketed in practice to retail investors, the task force decided against this approach. It concluded that the scope of the definition should not depend on whether a product was originally designed for retail customers. It accepted, however, that the PRIPs requirements should only apply when relevant products are to be sold to a retail client (see further below).

The task force concluded that the definition should recognise that a PRIP is a single product that assumes a packaged form. It therefore excludes any combined sale of products where each product keeps its original features. For example, if the sale involves a structured deposit which combines a deposit and a contract for differences ("CFD"), the entire product would be a PRIP. By comparison, a sale of an ordinary deposit and a CFD to the same investor would not subject the deposit to the PRIPs regime.

The task force gave consideration to specifying a non-exhaustive "white list" of PRIPs products to complement a legal definition. Although there were some concerns that products marketed under the same "label" often have different characteristics in different markets, the majority of members concluded that such a list would give rise to greater certainty as to which products are covered by the definition. It was however noted that the list would need to be continually reviewed and be flexible enough to accommodate further market developments.

The task force members unanimously agreed that the following types of products should be included within such a white list: (i) structured products of all kinds (including structured deposits), (ii) UCITS, (iii) non-UCITS funds, (iv) unit-linked and index-linked life insurance policies, (v) warrants (including covered warrants), (vi) asset-backed securities and other similar debt instruments, (vii) convertible shares and convertible bonds, and (viii) capital redemption operations linked to unit-linked investment funds.

There were differing views as to the treatment of certain products including derivatives, with profits life insurance and traditional life insurance investments that have profit sharing and hybrid life insurance products.

- *Pension products and annuities:* the task force concluded that pension related products (including annuities) be left out of the PRIPs scope for the time being, pending further work by CEIOPS and the Commission.
- *Structured deposits and structured investment products:* structured investment products were regarded as clearly meeting the criteria to be considered as PRIPs. It was also considered that structured deposits should be within the scope of PRIPs, although with differentiation of how specific requirements apply in

[4] European Commission's Update on Commission work on Packaged Retail Investment Products (16th December 2009), http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/20091215_prips_en.pdf. *See also*, European Commission publications from its Technical Workshop on PRIPs (Brussels 22nd October 2009): (i) Issues Paper: "Packaged Retail Investment Products: Issues for discussion," http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/2009-10-22_prips_en.pdf; and (ii) minutes: "Summary of Technical Workshop on Packaged Retail Investment Products," http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/minutes-prips-workshop-221009_en.pdf.

order to reflect the risks posed by structured deposits as opposed to (non-deposit) structured investment products which entail higher risks for investors.

- *With-profits and traditional life insurance products:* in relation to whether with-profits life insurance or traditional life insurance products should be within the scope of PRIPs, the task force believes further work is required, particularly as they present different product characteristics from one EU member state to another.

Product Disclosure

The task force stated that the UCITS Directive,[5] the Insurance Mediation Directive ("IMD"),[6] MiFID and the Prospectus Directive should all be taken into account in developing a common regime for PRIPs. It agrees with the view previously expressed by the Commission that information provided through a Key Investor Information ("KII") document, along the lines of that developed for UCITS, could usefully be applied to PRIPs.

It was however agreed that the form of KII document used for UCITS would need modification and tailoring as some information in a UCITS KII is specific to UCITS products. The task force also noted that following the forthcoming revision of the Prospectus Directive, it should be ensured there is appropriate harmonisation between the KII for PRIPs that are admitted to trading on a regulated market or issued in the form of securities and the KII to be produced under the Prospectus Directive. The majority of task force members believed that, as a general rule, the product manufacturer should be responsible for producing the KII, with the distributor responsible for delivering it to the investor. Some members however believed that for certain banking and insurance based PRIPs it is more appropriate for the product manufacturer to have the primary responsibility for delivering the KII where it is a party to the contract with the investor.

It was noted that for some PRIPs structures, questions may arise as to how many KIIs must be produced and what information they should cover. The task force stated that the key principle should be that the investor receives all relevant information about the underlying assets and the impact of the packaging (including the costs and charges of the underlying asset and the wrapper and their combined effect). Further details should be developed for different types of PRIPs.

The task force also considered what obligations should be imposed upon the distributor to inform the manufacturer of investor-specific factors in the PRIP. It identified two possible approaches. Its preferred approach is for a core standard KII reflecting the relevant product's features and legal forms, which does not contain tailored personalised information for the individual investor. Under this approach, the distributor would collect information from the investor regarding its situation (e.g., investment amount, objective and choice of underlying assets) and submit a proposal to the product manufacturer for approval. The personalised disclosure should be provided in a supplementary document. The second approach is that the standardised KII reflect the impact of different investor circumstances and choices on the product itself and cover all variables (e.g., the different charging structure of an insurance PRIP depending on the investor's age, investment amount or fund choice). It believed an approach would be likely to supply the investor with excess information and render the KII more difficult to understand.

Consideration was given to whether the KII should be subject to prior approval of the KII by a competent authority. The majority of task force members believed this may shift the responsibility for the KII away from the product provider to the competent authority and did not support this approach.

In order to aid the comparison of different PRIPs, the task force suggests that detailed requirements on common product information be developed in key common areas including:

- essential information describing the product, its structure and objectives;

[5] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF.

[6] EU Insurance Mediation Directive (2002/92/EC), http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l_009/l_00920030115en00030010.pdf.

- where the product contains a specific risk due to its structure, the KII should provide a narrative description, including its consequences and the likelihood of it occurring. The task force believed that the most effective approach to a disclosure of the risks associated with a PRIP is a combination of an overall risk rating and a narrative description;
- care should be taken in presenting information on returns and past performance to ensure that it is fair, clear and not misleading and that investors can compare products; and
- KIIs for PRIPs should provide information about all relevant costs to enable a fair comparison between different PRIPs.

The task force also specifically considered product disclosure for insurance based PRIPs and structured products. In relation to insurance based PRIPs it concluded that the disclosure must reflect product specific information. In relation to structured deposits, it concluded that disclosure should give special consideration to (i) information concerning the structure of the product, (ii) restrictions on the use of such terms as "guaranteed" or "capital protected", unless effective third-party guarantees or capital protections exist, (iii) full and clear disclosure of any penalties (e.g., for early withdrawal) and whether early withdrawal is not permitted, and (iv) discouraging banks from using potentially confusing names for structured deposits (e.g., by calling them "bonds" which suggests that they are investments).

Selling Practices

In relation to the distribution of PRIPs, the task force followed the approach previously taken by the Commission in taking the existing provisions contained in the Markets in Financial Instruments Directive ("MiFID")[7] as the benchmark, whilst recognising other relevant provisions, including the IMD's. It also recommended that the Commission should take the PRIPs regime into account when undertaking future reviews of relevant directives such as MiFID and the IMD.

Client categorisation

The task force noted that the MiFID regime provides a classification of different types of clients depending on their knowledge and experience and the requirements of firms dealing with clients depend upon such classification. Therefore, greater duties are imposed upon those dealing with retail clients. It also noted that the IMD does not generally make such a distinction. In relation to structured deposits, it considered these could be sold to retail or professional clients and the MiFID client categories should be extended. In relation to insurance based products, it considered that these are mainly sold to retail investors and as the PRIPs regime will only apply when a product is to be sold to retail investors, a MiFID style categorisation would not add much value for such products.

Advised and non-advised sales

In relation to advised sales, taking MiFID provisions as a benchmark, the task force stressed that the advice given to the investor must be suitable and the relevant standards for a suitability assessment should be consistent for all PRIPs to ensure a uniform level of investor protection. The task force suggests the following definition of advice under the PRIPs regime:

"A personal recommendation to an investor, either upon their request or at the initiative of the distributor, for a specific investment that is presented as suitable for that person, or is based on a consideration of the circumstances of that person."

The majority of task force members believed that no advice should be given, unless an investor discloses all relevant information about himself. This is on the grounds that it would not be possible to ensure that the advice

[7] EU Markets in Financial Instruments Directive (2004/39/EC), http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l_145/l_14520040430en00010044.pdf.

provided is suitable without knowing all relevant facts. On the other hand, a minority of task force members thought that a distributor should be permitted to give advice, subject to an appropriate warning.

A majority of task force members agreed that it should be possible to sell some PRIPs on a non-advised basis, if the investors are able to make their own decisions. As most PRIPs have complicated structures, a minority of task force members felt that all PRIPs should be regarded as complex. That would make the appropriateness test compulsory for all non-advised sales of PRIPs and prevent execution-only sales. This is an area that will need to be considered further by the Commission, including in the context of the MiFID review in relation to the treatment of UCITS products which are currently automatically non-complex.

Other issues relevant to selling practices

The task force also concluded that:

- the MiFID standard which requires that each firm "act honestly, fairly and professionally in accordance with the best interests of its clients" should be applied to all PRIPs;
- the MiFID principle of proportionality (whereby the fundamental regulatory requirements are applied to all firms but firms have the flexibility to adopt the implementing measures according to circumstances such as size, structure and complexity) should be applied across the PRIPs regime;
- the MiFID conflicts of interest provisions (based on the principle that firms must act in the best interests of their investors) should apply to all PRIPs; and
- inducements provisions should complement the conflicts of interest rules to avoid investor detriment. They should cover all payments made to the distributor (e.g., fees, commissions, non-monetary benefits). The task force concluded that MiFID inducements provisions provide a good starting point for the PRIPs regime. However, further work is needed to account for specific features of different types of PRIPs.

Next Steps

The Commission had originally intended to publish its draft legislative proposals by now but due to other commitments the consultation process in relation to PRIPs has taken longer than originally envisaged. The Commission has stated that it plans to hold a further consultation this year and a revised paper is expected shortly. It seems unlikely, however, that any draft legislation will be finalised until 2011. As highlighted in the Report, some elements of the PRIPs proposals are related to the ongoing MiFID review, particularly in relation to selling practices.[8]

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[8] *See* European Commission DG Internal Market and Services – Consultations and conferences planned for 2010, http://ec.europa.eu/internal_market/consultations/docs/2010/planned_en.pdf.

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