

EPFSF Briefing

“Retail Investment Protection Package”

Introduction

On 3 July 2012, the European Commission published a new set of legislative proposals which together form the “Retail Investment Protection Package”. The three proposals aim at enhancing investors’ protection and restoring consumer confidence. The Packaged Retail Investment Products (PRIPs) proposal, the revised Insurance Mediation Directive (IMD II) and UCITS V reflect the Commission’s steps to tackle the shortcomings in the retail financial services sector and the perceived lack of transparency, low awareness of risks, and poor handling of conflicts of interest.

The PRIPs proposal, at product level, is designed to overcome the asymmetry of information about investment products and to enable product comparison. Like the Key Investor Information Document (KIID) for investment funds under the UCITS IV Directive, the Key Information Document (KID) under the PRIPs proposal aims at informing consumers in an easy format about the main features, risks and costs associated with investing in a packaged investment product.

The revised Insurance Mediation Directive seeks to improve regulation in the retail insurance market in an efficient manner. It aims at ensuring a level playing field between all participants involved in the selling of insurance products and at strengthening policyholder protection. For “insurance-based investment products” (PRIPs life insurance products), IMD II seeks an alignment with the current revision of MiFID (MiFID II).

The UCITS V proposal aims at improving the current UCITS framework to further increase investors’ protection by enhancing the depositary regime, the disclosure of risk associated with the safe-keeping of financial instruments and on the remuneration and sanctions regimes. In many aspects, the liability regime is aligned with AIFMD.

This briefing paper highlights the key aspects of the Retail Investment Protection Package proposals.

Packaged Retail Investment Products (PRIPs)

Key information document for retail investment products

Background:

The PRIPs initiative reflects the Commission's concern that the different products for delivering packaged investment propositions to retail investors are subject to different regulatory regimes. In particular, the Commission suggests that the current regulation of disclosure creates an unlevel playing field for different products and persons selling investment products and does not adequately assist investors in understanding and comparing products. The introduction of a mandatory short form key information document or KID is intended to address these concerns. The form and prescriptive nature of the KID proposed for PRIPs is informed by the experience gained in the context of the UCITS Directive. The simplified prospectus for UCITS introduced in 2001 was intended to provide key information to consumers in order for them to make an informed investment decision but proved to be a failure because of the lack of standardization in terms of content and format of the document. These shortcomings led to the replacement of this document by a pre-defined format key investor information document (KIID) to communicate the necessary information to the end investors and to enable such investors to compare UCITS funds among themselves. Experience of the UCITS KIID, which has been implemented recently, should, therefore, provide a useful point of reference for the development of elements of the KID for PRIPs. Allowances will, however, need to be made for the distinct differences between UCITS and features of different types of PRIPs products. The Commission has proposed a new Regulation for Packaged Retail Investment Products to form the legislative basis for the PRIPs KID regime.

The objective of PRIPs is to improve the disclosure of the characteristics, costs and risks associated with retail investment products and this in a standardized format. The KID aims also to improve the comparability of the financial products in order to facilitate the consumer investment decision process.

Scope:

As per the Commission's proposal, the scope of PRIPs includes products with capital guarantees, and those where, in addition to capital, a proportion of the return is also guaranteed; investment funds, whether closed-ended or open-ended including UCITS; many structured products, whatever their form, insurance products whose surrender values are determined indirectly by returns on the insurance companies' own investments or even the profitability of the insurance company itself as well as derivative instruments. The PRIPs scope is an outstanding issue that needs to be clarified.

Format and content:

In terms of content and format, the PRIPs KID aims to achieve a similar approach to that of the UCITS KIID. The KID aims at being a fair, clear and not misleading stand-alone document. It takes into account the specificities of investment products, to some extent, allowing the product manufacturer to include other information where it is necessary to assist consumers in their product consideration although it is not clear if such a decision is expected to be based purely on the information contained in the KID. Moreover, with the possibility for additional information, combined with no restrictions in terms of the length of the document, concerns have been raised on the achievement of this objective and on the ability to actually be able to compare investment products. This is however subject to Commission delegated acts on the presentation and details of this additional information. It will be important to strike a balance between allowing enough space for good quality investor friendly disclosure to be included whilst ensuring the document allows for comparability. Furthermore, given that the PRIPs KID is intended to be a standalone document, it will be important to clarify the status of the other contractual and regulated disclosure documentation (e.g. any prospectus under the Prospectus Directive).

In order to strengthen the comparability of products and to provide the necessary information to the end consumers, the KID, as proposed by the Commission, sets a number of sections with pre-defined titles such as "Could I lose money?" or "What might I get when I retire?". Concerns have been raised about the labeling of the sections of the KID as they could be misleading for consumers.

Provision of the KID:

The current proposal contains derogations that allow firms to provide a retail investor with the KID after the relevant transaction has completed for internet and distance communications. These resolve issues faced by the fact that the UCITS KIID must be provided before the transaction is completed.

For discretionary business, the PRIPs proposal does not take into account the role of discretionary managers in acting on behalf of the retail client and therefore needing to be the recipient of the KID from the product manufacturer. Concerns have been raised about the absence of such a provision which is not in line with the practical operation of the UCITS KIID.

Civil liability regime:

From a civil liability perspective, once an investor has established that it has suffered a loss, the Regulation proposes that it will be for the investment product manufacturer to prove that it has complied with the terms of the Regulation in preparing the PRIPs KID. This poses a number of questions in respect of interaction with existing Member State civil liability regimes and the protections already provided for by these regimes. This will warrant further consideration.

Delegated acts:

The Level 1 Regulation will eventually be complemented with detailed guidelines in order to obtain a common interpretation of the intended objective of the proposal and to be able to compare investment products, but also to adapt the design and the content of the KID to the specificities of each investment products' category (investment funds, life insurance, structured deposits,). Given the scope of the proposed Regulation, different financial actors are impacted by the proposal and all actors do not have the same oversight in terms of regulators. The Commission proposes delegated acts for certain sections of the proposed Regulation. With a joint approach by the three ESAs to draft technical standards for the entire proposal; will it strengthen a common level playing field across financial actors and products?

Status of the KID:

The proposal clearly mentions that the KID is not a marketing document. However, the pre-contractual nature of the document is not clearly specified as it is for the UCITS KIID.

UCITS KIID:

Following the implementation of the UCITS KIID, some Member States extended the scope of the KIID to other open-ended retail investment funds. This allows consumers to further compare UCITS funds with other non-UCITS funds. The current proposal for the PRIPs KID, allows a five-year period for which the UCITS funds are exempted to produce a PRIPs KID. As part of the review clause of the PRIPs KID the question can be raised whether a wider review of both the UCITS KIID and PRIPs KID would be appropriate?

Prospectus Directive:

The proposal envisages that a product manufacturer – subject to the obligations of the Regulation and of the Prospectus Directive (2003/71/EC) - must draw up both the summary note (as a part of the prospectus) and the KID. The same provision is provided for insurance products covered by 2009/138/EC Directive.

As the summary note of the Prospectus Directive and the KID fulfill the same aim to deliver synthetic information that would enable clear comparison between different products for the investor, the requirement to produce a PD Issue Specific Summary should be removed where a KID is produced. This would avoid an overlap of documents which would further confuse the investor.

Definition of investment product manufacturer:

Under the current proposal, there are concerns that the definition of an investment product manufacturer could include intermediary investment managers and stockbrokers because of the costs associated with purchasing products on behalf of clients, giving advice or managing a client portfolio. It would, however, seem highly unlikely that this is what is intended but it should be clear in the text that such intermediaries are excluded from the definition.

Insurance Mediation Directive review (IMD II)

The revision of the IMD aims at increasing policyholder protection by creating common standards for advice and the sale of insurance products within the European Union.

IMD II aims to strengthen disclosure and enhance transparency of selling products. It introduces the obligation for an assessment of suitability and appropriateness for the sale of insurance PRIPs to consumers.

To achieve a level playing field in the distribution and selling of insurance products, it is important that IMD II and MiFID II are aligned and notably in regards to inducement rules. There is still some work needed to achieve this.

IMD II should provide provisions on the marketing and selling of all types of insurance PRIPs and MiFID II for other PRIPs.

However, clarification should be introduced into IMD II that the sale of insurance PRIPs should not be subject to cumulative sets of conduct of business rules (ie the rules for other types of insurance products, as well as rules for insurance PRIPs) nor be under stricter rules than MiFID II PRIPs products.

UCITS V

The Commission proposal on UCITS V comes following the financial crisis to further increase investor's protection in terms of the "safe keeping" of assets and increase market integrity. In this regard, UCITS V aims to reinforce the followings aspects:

- A precise definition of the tasks and liabilities of all depositaries acting on behalf of a UCITS fund;
- Clear rules on the remuneration of UCITS manager: the way they are remunerated should not encourage excessive risk-taking. Remuneration policy will be better linked with the long-term interest of investors and the achievement of the investment objectives of the UCITS; and
- A common approach to how core breaches of the UCITS legal framework are sanctioned, introducing common standards on the levels of administrative fines so as to ensure they always exceed potential benefits derived from the violation of provisions.

UCITS V has for primary hypothesis an alignment with the AIFMD. However, there are certain additional restrictions due to UCITS which are designed for retail investors. Notably these are in terms of discharge of liability in case of delegation of the custody functions. In certain jurisdictions, national law has a requirement that the purchase of assets remains under custody within that jurisdiction. This situation will lead for the UCITS to avoid investing in certain type of assets and it will create fewer opportunities for investors in terms of asset allocation and risk diversification.

It is important to recognize that this strengthening of the depositary regime will inevitably have an impact on the returns that investors may expect from their investments in UCITS due to cost increase. It is therefore important to find the right balance between what is acceptable in terms of risks and in terms of investors' returns. Serious concerns have also been expressed by industry participants as to the fact that some of the conditions for the delegation of the custody function in the Commission's proposal appear too restrictive, which could ultimately lead to preventing UCITS from investing in a number of jurisdictions.

On the remuneration aspects of the proposal, the principles for UCITS Management Companies should be as far as possible consistent with those applicable to AIFMs without yet being entirely identical. They need to take into account the differences in business models of banks and asset managers. They should integrate the notion of proportionality.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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