PRIIPS KID – THE NEW DISCLOSURE DOCUMENT FOR MANUFACTURERS AND DISTRIBUTORS OF FUNDS, STRUCTURED SECURITIES AND OTHER PACKAGED INVESTMENT PRODUCTS

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Investment Management Alert

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Commencing on 1 January 2018, European and non-European entities or persons producing or selling packaged retail investment and insurance-based products (so-called **PRIIPs**) to retail investors in Europe, will be required under the PRIIPs Regulation[1] to produce a key information document (**PRIIPs KID**). This alert provides an overview of the key features of PRIIPs KIDs, which:

- may apply to **investment funds**, **structured securities** and **structured deposits**, as well as certain **long-term insurance contracts** - *see "What products are covered?"*
- are a **pre-contractual** disclosure document that is required where a PRIIP is **made available to retail investors** - *see "Who must a PRIIPs KID be provided to, when and where?"*
- have a **highly prescribed** form and content - *see "Content of PRIIPs KIDs"*

BACKGROUND

Why are PRIIPs KIDs being introduced?

During the financial crises, many retail investors lost money through investments that carried risks that were not transparent to or understood by them. That, combined with European legislators' greater awareness of and determination to address the increasing complexity and lack of comparability of retail investment products, gave rise to the PRIIPs KID proposals published by the European Commission in 2012.[2] Its objectives included the following:

- Improving transparency for retail investors into the risks of investment products.
- Eliminating asymmetries of information between retail investors and those designing and selling investment products.
- Helping retail investors to understand and compare the key features and risks of investment products.

Timing and status of legislation

The core rules for PRIIPs KIDs are set out in the PRIIPs Regulation and regulatory technical standards (**RTS**)

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prepared by the European Supervisory Authorities (**ESAs**). Concerns raised by the European Parliament resulted in a rejection of the original RTS in 2016 and a 12-month deferral of the implementation date of the PRIIPs Regulation. Following revisions by the European Commission, the RTS has now been finalised and adopted in the form of a **Delegated Regulation**[3], which is directly applicable in member states. Implementation is scheduled for **1 January 2018**.

SCOPE

What products are covered?

The term "PRIIP" comprises both so-called packaged retail investment products and insurance-based investment products.

- A "**packaged retail investment product**" or "**PRIP**" is defined as an investment where, regardless of the legal form of the investment, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets (Underlying Investments) which are not directly purchased by the retail investor. Examples include investment funds, structured securities, structured deposits, derivatives and asset backed securities. This would also include Undertakings for Collective investment in Transferable Securities (**UCITS**) funds, but see *"Transitional exemption for UCITS (and other non-UCITS retail funds)"* below.
- "**Insurance-based investment products**" are defined as products which offer a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations. Examples include life insurance products, where the benefits under the contract are payable not only on death or in respect of incapacity due to injury, sickness or infirmity.

Transitional exemption for UCITS (and other non-UCITS retail funds)

With respect to UCITS funds, there is a transitional exemption period until 31 December 2019. The European Commission is mandated to review the position by 31 December 2018 and decide whether to allow the transitional exemption to lapse, or to extend the transitional exemption or deem the existing UCITS KIID to be sufficient.

The transitional exemption is also available to any non-UCITS funds offered to retail clients for which, according to the national rules of a member state, there is already an obligation to provide a Key Investor Information Document pursuant to the UCITS Directive[4]. The UK authorised fund category of non-UCITS retail scheme is able to avail itself of this.

Who must a PRIIPs KID be provided to, when and where?

- **Who?** The PRIIPs Regulation is meant to protect **Retail Investors**, i.e. retail clients within the meaning of the MiFID[5] MiFID II[6] and non-MiFID professional customers within the meaning of the IMD[7]. This may include categories of investor that one might not ordinarily regard as being typically retail, for example, high net worth investors in the UK and semi-professional investors in Germany[8].
- **When?** A PRIIPs KID must be provided in good time **before the investor is bound** by any contract or offer relating to a PRIIP when a PRIIP is **made available to Retail Investors**. A PRIIPs KID is not

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required for PRIIPs that are not sold to Retail Investors, although there are complexities around what this means in practice.

- **Where?** Manufacturers and distributors of PRIIPs will be required to provide a PRIIPs KID for PRIIPs that are made available to Retail Investors within the European Economic Area (**EEA**); this also applies to entities and persons from or based in third countries (i.e. outside the EEA). Consequently **both EEA and non-EEA firms may need to produce a PRIIPs KID.** Where a PRIIP is only made available to investors outside the EEA, a KID is **not** required.

CONTENT OF PRIIPS KIDS

Who is responsible for drawing up and providing a KID?

A KID must be drawn up and published on its website by the relevant **Manufacturer**, i.e. the entity that manufactures the PRIIP or the entity that makes changes to an existing PRIIP (e.g. by altering the risk and reward profile or the costs).

In addition, any person advising on, or selling, a PRIIP in the primary as well as in the secondary market must provide a KID to the Retail Investor. It may be provided either in paper-form, on another durable medium (e.g. CD-ROM, DVD or email), or by a website.

What will a KID have to look like?

The KID shall be a short document with a **maximum of three sides of A4-sized paper**. It shall be easy to read, focus on the relevant key information for Retail Investors, and be in clear, succinct and comprehensive language. It shall be written in the official or any other accepted language of the member state where the PRIIP is offered or sold. In addition, it must be translated into all corresponding official languages in which marketing documents are used.

The KID is divided into a number of sections, which inter alia set out:

- information on the identity of the Manufacturer and its competent authority;
- a prescribed comprehension alert (where applicable);
- specification of the PRIIP's "type", its objective and the intended market;
- details of the risks associated with the PRIIP and a summary risk indicator;
- performance scenarios;
- the consequences of a potential default of the Manufacturer; and
- the costs of the PRIIP.

The Delegated Regulation includes a template for the KID and requires that Manufacturers shall not deviate from the KID template and other details laid down in the Delegated Regulation.

What is the summary risk indicator?

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The summary risk indicator (**SRI**) is a numeric figure that provides **information on the risk profile of the PRIIP** on a scale from 1 (lower risk) to 7 (higher risk). It is identified by combining a market risk measure (**MRM**) and a credit risk measure (**CRM**) with respect to the PRIIP.

The MRM indicates the PRIIP's market risk on a scale from 1 (lower risk) to 7 (higher risk). In principle, the relevant MRM is assigned on the basis of available market prices and the annualised volatility corresponding to the value-at-risk at a confidence level of 97.5% over the recommended holding period according to the rules laid down in the Delegated Regulation.

The CRM indicates the PRIIP's credit risk on a scale from 1 (lower risk) to 6 (higher risk). The CRM takes into account the credit risk associated with the Manufacturer or the party bound to make, directly or indirectly, payments to the investor. If a PRIIP is exposed to underlying investments or techniques which themselves entail credit risk, the credit risk assessment will also take into account the underlying investments or exposures on a look through basis.

Which performance scenarios must be presented in the KID?

The KID must contain performance scenarios which shall show a range of **possible returns in a stressed, an unfavourable, a moderate and a favourable development** of the underlying instrument(s). In case of insurance-based investment products, an additional scenario, based on the moderate scenario shall be included, where the performance is relevant in respect of the return of the investment.

In principle, scenario values must be calculated with respect to each performance scenario for periods equal to the recommended holding period, the half of the recommended holding period and one year. The scenario values must be calculated net of all applicable costs and presented in monetary units and in percentage terms. The Delegated Regulation provides specific details with respect to the calculation and presentation of the scenario values.

Which costs must be disclosed in the KID?

In principle, **all direct and indirect costs associated with an investment in the PRIIP**, including one-off costs (such as entry and exit costs), recurring costs (such as portfolio transaction costs per year, and other recurring costs per year) and incidental costs (such as performance fees or carried interest) must be disclosed in the KID. The Delegated Regulation provides a list of examples of costs, which must be disclosed in a KID together with specific details for their calculation.

The total aggregated costs of the PRIIP must be presented in the form of a **summary cost indicator** (**SCIs**) as a single number in monetary and percentage terms for an assumed investment of EUR 10,000 (for all PRIIPs except regular premium insurance-based investment products) or EUR 1,000 yearly (for regular premium insurance-based investment products) during the holding periods used in the presentation of the performance scenarios. In addition, the impact each year of the different types of costs on the investment return must be presented as cost ratios in percentage terms. The SCI and the cost ratios must be calculated on the basis of the reduction in yield method as specified in detail in the Delegated Regulation.

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OTHER ASPECTS

When must a KID be updated?

The Manufacturer must **regularly review** and, if necessary, revise the KID as long as the PRIIP is offered or sold. The review of the information contained in the KID shall be done every time there is a change that significantly affects or is likely to significantly affect the information contained in the KID and, at least, every twelve months following the date of the initial publication of the KID. After a revision of the KID, the Manufacturer must publish the revised KID on its website.

What is the liability risk?

The liability for a **misleading** or **inaccurate** KID or for a KID which is **inconsistent** with the relevant parts of the legally binding pre-contractual and contractual documents or with the formal requirements laid down in the PRIIPs Regulation lies with the Manufacturer. Damages for a loss resulting from the reliance on a KID may be claimed in accordance with applicable national law.

Regime for multi-option PRIIPs

A multi-option PRIIP is a PRIIP that offers a **range of underlying investment options** (for example fund-linked life insurance products). If, in this case, the information regarding those underlying investment options cannot be provided within a single KID, the Manufacturer may choose to either produce a **single KID for each underlying investment option** within the PRIIP (including information about the PRIIP according to the general principles described above) or produce what is referred to as a "**generic KID**".

If the Manufacturer decides to produce a generic KID, the Manufacturer may describe only the types of underlying investment options and specify ranges of risk classes and costs together with an indication where the specific information on each underlying investment option is to be found. With respect to the specific information on each underlying investment option, the Manufacturer must, in addition to the generic KID, either create for each underlying investment option a "**mini-KID**", which contains the comprehension alert (were relevant), a description of the investment objectives and the intended target market, the SRI, the performance scenarios and the presentation of costs or, if at least one of the underlying investment options is a UCITS or a non-UCITS for which, according to the national rules of a member state, a UCITS-KIID must be drawn up, the Manufacturer may refer to and provide the UCITS-KIID instead.

Notes:

1. Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).

2. European Commission Proposal for a Regulation of the European Parliament and of the Council on key information documents for investment products 2012/0169 (COD) published on 3 July 2012.

3. Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 supplementing the PRIIPs Regulation.

4. Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

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5. Directive 2004/39/EU of 21 May 2004 on markets in financial instruments.

6. Directive 2014/65/EU of 15 May 2014 on markets in financial instruments.

7. Directive 2002/92/EC of 9 December 2002 on insurance mediation.

8. Section 1 (19) no. 33 of the German Capital Investment Code (*Kapitalanlagegesetzbuch* - KAGB)

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