

# **The Regulation on Key Investor Documents for Packaged Retail and Insurance-Based Investment Products**

## **Key Points for EU and Non-EU Asset Managers**

A Legal Update from Dechert's Financial Services Practice

July 2016

## Introduction

In addition to the [challenges of MiFID II](#), asset managers must also prepare for a new key information document regime for retail products. The Regulation on key information documents for packaged retail and insurance-based investment products (Regulation 1286/2014) (more widely known as “**PRIIPs**”, and referred to here as the “**Regulation**”) has been labeled “*arguably the most extensive and complex joint work stream that has been tackled by the European Supervisory Authorities (ESAs)*”<sup>1</sup>. The Regulation cuts across different sector-specific initiatives in order to improve and consolidate the EU regulatory framework for pre-contractual disclosures to retail investors, and seeks to enable retail investors to understand better and compare the financial products available to them within the EU.

While PRIIPs is aimed at the European retail market for insurance and fund products, it is relevant to any alternative fund manager who may market its products to individuals or entities in Europe who come within the definition of a retail investor.

This Regulation will apply to producers and distributors of PRIIPs that are sold to retail investors in the EU regardless of their jurisdiction, and as such may have a significant impact on non-EU managers.

## Timings and consultations

The Regulation was published in the Official Journal of the EU on 9 December 2014 and entered into force on 29 December 2014. Its requirements will apply to firms from 31 December 2016. By 31 December 2018, the Commission must review the Regulation, and assess in particular whether the UCITS transitional period (discussed further below) which is due to end 31 December 2019, should be prolonged or whether the UCITS Key Investor Information Document (KIID) provisions should be replaced by the Key Information Document (KID) provisions set out in the Regulation.

The final Level 2 Regulatory Technical Standards were published by the European Commission on 30 June 2016 and will enter into force twenty days following publication in the Official Journal. Notwithstanding calls from certain trade bodies for a delay to PRIIPs to allow market participants a more reasonable time frame in which to come into compliance, the publication of final Level 2 rules means that firms must work to the 31 December 2016 deadline for compliance.

## What is a “PRIIP”?

The Regulation applies to packaged retail and insurance-based investment products, otherwise known as “PRIIPs”. Subject to certain exceptions, the Regulation applies to products, regardless of the product’s form or construction, which are manufactured by the financial services industry to provide investment opportunities to retail investors<sup>2</sup>. The “PRIIPs” label is shorthand for two distinct types of product:

- ▶ packaged retail investment products; and
- ▶ insurance based investment products.

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<sup>1</sup> Steven Maijoor, Chair of the European Securities and Markets Authority, 5 November 2014.

<sup>2</sup> Recital 6 of the Regulation

## Packaged retail investment products

Packaged retail investment products are investments, including instruments issued by special purpose vehicles (SPVs), where, regardless of the legal form of the investment, the amount repayable to the investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor<sup>3</sup>.

## Insurance based investment products

Insurance based investment products are insurance 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.

While the product definitions are intentionally wide, it should be remembered that to fall under the PRIIPs regime, such products must be **sold to retail investors**.

## Examples

The following products would therefore be classed as “PRIIPs”:

- ▶ investment funds;
- ▶ life insurance policies with an investment element;
- ▶ structured investment products;
- ▶ structured deposits; and
- ▶ instruments issues by SPVs where they meet the definition of a PRIIP.

## Exceptions

The Regulation does not apply to:

- ▶ non-life insurance products<sup>4</sup>;
- ▶ deposits other than structured deposits;
- ▶ vanilla shares;
- ▶ government bonds; and
- ▶ certain pension products recognised by Member States as retirement products.

## What is a KID?

The Regulation requires that, before a PRIIP is made available to retail investors, a Key Information Document (KID) must be provided to those investors. A KID is thus a form of pre-contractual disclosure document, such as that already required under the UCITS Directive. The KID must be accurate, fair and not misleading, whilst remaining consistent with any binding contractual or offering documents associated with the relevant PRIIP to which the KID applies. It must be a short, standalone document, written in a concise manner and covering a

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<sup>3</sup> Article 4(1) of the Regulation

<sup>4</sup> As listed in Annex I to Solvency II

maximum of three sides of A4 paper when printed. It must promote comparability across products, be written in the language of the Member State in which the PRIIP is distributed and in language that is clear, succinct and comprehensible.

The Regulation acknowledges that these requirements might be difficult to meet in some circumstances, and provides that where a PRIIP offers a range of investment options such that all required information cannot be provided within a single, concise, stand-alone document, a generic description of the PRIIP is permitted, provided that the KID states where further information on the product may be found. The Level 2 rules confirm that a one size fits all approach may not be suitable for PRIIPs offering multiple investment options.

## What must be included in a PRIIPS KID?

The PRIIPS KID regime is an attempt to standardise pre-contractual disclosures to retail investors across a broad product range, in a way that promotes comparability across products. In line with this goal, the Regulation is prescriptive, and requires all KIDs contain certain information, as detailed in the table below.

| KIID Section  | What must be included  |
|---|--|
| <b>Title</b>  | The title “Key Information Document” must appear prominently at the top of the first page.   |
| <b>Explanatory statement</b>                                | An explanatory statement must appear under the title, as follows:<br><br><i>“This document provides you with key information about this investment product. It is not marketing material. The information is required by law to help you understand the nature, risks, costs, potential gains and losses of this product and to help you compare it with other products.”</i>  |
| <b>Basic details</b>  | The name of the PRIIP, the identity and the contact details of the PRIIP manufacturer, information on the competent authority of the PRIIP manufacturer and the date of the document must be included at the beginning of the document.  |
| <b>Comprehension alert (if applicable)</b>                  | Where applicable, a PRIIP must include a comprehension alert, as follows:<br><br><i>“You are about to purchase a product that is not simple and may be difficult to understand.”</i>   |
| <b>“What is this product?”</b>                              | Under a section titled “What is this product?”, the nature and main features of the PRIIP must be detailed, including the type of PRIIP, its objectives and a description of the target investors.   |
| <b>“What are the risks and what could I get in return?”</b> | Under a section titled “What are the risks and what could I get in return?”, a brief description of the risk-reward profile of the PRIIP should be included. This should comprise the following:<br><br><ul style="list-style-type: none"> <li>- a summary risk indicator, supplemented by a narrative explanation of the indicator, its limitations, and the risks associated with the PRIIP that may not be adequately captured by the indicator;</li> <li>- the possible maximum loss of invested capital, including whether the investor can lose all invested capital, whether there is a risk of additional capital</li> </ul> |

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|   | <p>commitments, and whether the PRIIP includes capital protection against market risk;</p> <ul style="list-style-type: none"> <li>- appropriate performance scenarios, and the assumptions made to produce them;</li> <li>- where applicable, information on conditions for returns to retail investors or built-in performance caps; and</li> <li>- a statement that the tax legislation of the retail investor's Member State may impact the actual payout.</li> </ul> |
| <b>“What happens if [the manufacturer] is unable to payout?”</b>      | Under a section titled “What happens if [the manufacturer] is unable to payout?”, a brief description of whether the related loss is covered by an investor compensation or guarantee scheme must be included.   |
| <b>“What are the costs?”</b>  | Under a section title “What are the costs?”, the costs associated with an investment in the PRIIP, comprising both direct and indirect costs to be borne by the retail investor (including one off and recurring costs) shall be presented using summary indicators. To ensure comparability, total aggregate costs expressed in monetary and percentage terms should be included to show the compound effects of the total costs on the investment.                     |
| <b>“How long should I hold it and can I take my money out early?”</b> | Under a section headed “How long should I hold it and can I take my money out early?”, details of any cooling off or cancellation period should be provided, along with any potential fees or penalties for early disinvestment.   |
| <b>“How can I complain?”</b>  | Under a section titled “How can I complain?”, information about how and to whom a retail investor may complain about the product, the conduct of the manufacturer or the person advising on or selling the PRIIP should be provided.   |
| <b>“Other relevant information”</b>                                   | Under a section titled “Other relevant information”, any additional information documents to be provided to the retail investor at the pre- or post- contractual stage should be detailed (excluding any marketing material).  |

## How often should a KID be updated?

PRIIP manufacturers must review the information contained in the KID “regularly”, and revise the document where the review indicates that changes need to be made. The revised version must then be made available “promptly”.

The Level 2 rules establish that PRIIP manufacturers must review the information contained in the KID 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 initial publication of the KID. PRIIP manufacturers must establish and maintain adequate processes throughout the life of the PRIIP where it remains available to retail investors to identify without undue delay any circumstances which might result in a change that affects (or is likely to affect) the accuracy, fairness or clarity of the information contained in the KID. Any revisions required must be made without undue delay, and all sections of the KID affected must be updated. The PRIIP manufacturer must publish the revised KID on its website.

## Requirement to “provide”

The Regulation requires that a person advising on or selling a PRIIP must “provide” to retail investors in “good time”<sup>5</sup> and free of charge<sup>6</sup> the relevant KID **before** the retail investor is bound by any contract. The KID should be provided on paper where the PRIIP is offered to a retail investor on a face-to-face basis. The obligation to produce a KID is placed on PRIIPs manufacturers<sup>7</sup>, as they are best placed to understand the risks of the product. The obligation to “provide” a KID is placed on persons advising on or selling the PRIIP<sup>8</sup>.

### Ex-post provision of the KID

As an exception to the general rule that a KID should be provided before the conclusion of a transaction, the Regulation allows for the provision of the KID after the conclusion of a transaction in certain circumstances. The KID must be provided after the conclusion of the transaction without “undue delay”, where all of the following conditions are met:

- ▶ the retail investor contacts the person selling the PRIIP on his own initiative and concludes the transaction using a means of distance communication;
- ▶ the provision of the KID is not possible;
- ▶ the person advising on or selling the PRIIP has informed the retail investor that provision of the PRIIP is not possible and has clearly provided the retail investor an opportunity to delay the transaction to receive the KID; and
- ▶ the retail investor consents to receiving the KID without undue delay after the conclusion of the transaction, rather than delaying the transaction to receive it in advance.

### Website Provision of the KID

The requirement to “provide” the KID may be satisfied through the use of a website where all of the following conditions are met:

- ▶ where it is appropriate in the context of the business conducted between the person advising on or selling the PRIIP and the retail investor;
- ▶ where the retail investor has been given the choice between information provided on paper and by means of a website and has chosen the latter in a way that can be evidenced;
- ▶ where the retail investor has been notified electronically or in written form of the address of the website, and the place on the website where the KID can be accessed; and
- ▶ where the KID remains accessible on the website, capable of being downloaded and stored in a durable medium, for such reasonable time as the retail investor may need to consult it.

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<sup>5</sup> Article 13.1

<sup>6</sup> Article 14.1

<sup>7</sup> Article 5

<sup>8</sup> Articles 13 and 14

## Liability and product intervention

Retail investors that demonstrate loss, having invested in a PRIIP in reliance on a KID, can claim damages under national law provided that the KID relied upon is:

- ▶ misleading;
- ▶ inaccurate;
- ▶ inconsistent with the relevant parts of legally binding pre-contractual and contractual documents; or
- ▶ inconsistent with the requirements of the Regulation (as detailed in section 6 above).

In addition to this liability in national law, the Regulation establishes new market monitoring and product intervention powers to be exercised by the European Insurance and Occupational Pensions Authority (“**EIOPA**”). The Regulation provides that EIOPA may temporarily prohibit or restrict within the EU:

- ▶ the marketing, distribution or sale of certain insurance based investment products; or
- ▶ a type of financial activity or practice of an insurance or reinsurance undertaking.

The Regulation notes that these powers extend to the competent authorities where such activity occurs in or from its member state.

These product intervention powers, in practice, extend the product intervention powers in MiFID II to any PRIIPs that would not otherwise fall under the ambit of MiFID II, mainly investment-based insurance products. Whether these powers will be used remains to be seen.

## Transitional period for UCITS

The Regulation provides a temporary exemption for management companies and investment companies advising on or selling units of UCITS until 31 December 2019, by which time the Regulation must have been reviewed and an assessment made as to whether the temporary exemption should be extended or whether the PRIIPS KID should replace the UCITS KIID regime. This UCITS transitional period also applies where Member States apply rules on the format of a KID to Non-UCITS funds offered to retail investors (for example, Non-UCITS Retail Schemes (NURS) within the United Kingdom).

## Interaction with other disclosure requirements

The PRIIPS KID regime will exist in parallel to the disclosure requirements of the Prospectus Directive, UCITS IV, Solvency II, the Insurance Mediation Directive II and MiFID II. It will be particularly important for firms with a broad range of products requiring compliance with a variety of these different disclosure regimes to be certain of their obligations under the different regimes to ensure that there are no gaps in compliance.

It will be particularly important to understand your MiFID II disclosure requirements, and how these interact with PRIIPs. MiFID II disclosure requirements will generally apply to disclosures in respect of “financial instruments” to

any clients, whereas PRIIPs disclosures are only required where PRIIPs (as described above) are sold to retail investors.

## Costs disclosures – how to deal with transaction costs?

One of the key issues for asset managers is costs disclosures, in particular how to deal with the disclosure of transaction costs. Transaction costs are particularly difficult to calculate as they are an unpredictable product of the investment strategy. For example, an actively managed portfolio of global equities may move from being US- to UK-focused, and in doing so face potential stamp duty costs on the purchase of UK shares. The costs would differ if the move were reversed, as stamp duty is not chargeable on share disposals. Transaction costs and taxes vary across products and jurisdictions, and there are concerns that providing estimates of transaction costs will present a misleading picture of the actual figure, and may even create a disincentive to trade in some situations, to the detriment of investors.

The disclosure of transaction costs as required by the Regulation differs from the UCITS regime, where the ongoing charges figure (OCF) excludes transaction costs. MiFID II requires that information on “*all costs and charges*”, which are not caused by the occurrence of underlying market risk, must be aggregated and provided to the client on a regular basis.

This leads to a situation where the disclosures made under a PRIIPs KID will be sufficient for a firm to rely upon them to satisfy its own MiFID II costs disclosure obligations, whereas disclosures made under a UCITS KIID will not necessarily be sufficient. ESMA has suggested<sup>9</sup> that where transaction costs are missing from a UCITS KIID, firms should liaise with the relevant UCITS management company to obtain the relevant information. This is clearly an unsatisfactory outcome, as the management company is under no obligation to provide the requested information and without it, the investment firm cannot discharge its own MiFID II obligations.

Recital 78 of MiFID says that a disclosure under EU law such as PRIIPs should be sufficient for MiFID II purposes. However, the FCA in a previous MiFID II implementation meeting took the view that, where PRIIPs and MiFID II disclosure requirements differ, firms must take a judgement on what is “fair, clear and not misleading”, and should be making qualitative judgements as to what information needs to be disclosed.

The Level 2 rules set out the detail regarding the methodology for calculating transaction costs for the purpose of the PRIIPS KID. Asset managers must now prepare for an additional work stream for the publication of transaction costs.

## Key challenges for asset managers

Some of the issues that asset managers should be considering are:

- ▶ how comparability of different products will effect competition;
- ▶ that investors and distributors are likely to favour products with well written and accessible KIDs;
- ▶ asset managers may wish to streamline their product offerings to mitigate the increased costs of this regime;

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<sup>9</sup> In its Final Report - Technical Advice to the Commission on MiFID II and MiFIR dated 19 December 2014



- ▶ the operational challenges in producing large volumes of KIDs and making them available to distributors and investors in a timely and efficient way;
- ▶ staff will need to be trained in the requirements of the new regulation; and
- ▶ asset managers may wish to review distribution agreements and insert representations that distributors will act in compliance with the Regulation.

## Summary

The PRIIPS regime is a significant piece of EU regulation and presents a number of challenges for asset managers. It remains to be seen how it will work in practice. It is questionable whether standardisation of disclosure across such a diverse product range can be achieved in a meaningful way, and it can be argued that providing investors with standardised disclosure documents that seem comparable (i.e. through risk indicators) may induce a false sense of security.

Notwithstanding the regimes shortcomings, the Regulation does mark a change in direction of EU financial market regulation, away from concerns over financial stability towards the encouragement of economic growth through engagement with financial markets (and regaining retail investor confidence in financial markets following the financial crisis). Asset managers with well-written KIDs and efficient compliance processes will be best placed to service retail investors from 2017 onwards.

For further advice on navigating the new disclosure landscape, please contact a member of the Dechert team:



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