



Structured Thoughts

News for the financial services community.

Structured Products Regulatory Developments: an update on the EU actions on PRIPs

In the year since the Lehman failure, we have seen quite a number of regulatory initiatives relating to structured product sales in the EU and in Asia. We are devoting the next few issues of this newsletter to a review of the principal developments affecting the structured products market in the EU.

Background – The EU Financial Package

The European Commission (the “Commission”)’s initiative on packaged retail investment products (“PRIPs”), i.e., retail investment products (“RIPs”), which are packaged and marketed to retail investors, forms part of the “financial package” announced by EU Commissioner Charlie McCreevy in a press conference on 29th April 2009.¹ The EU financial package also included:

- a proposed directive on alternative investment fund managers, including hedge funds and private equity (the “AIFM Directive”);² and
- two recommendations by the Commission on remuneration policies for risk-taking staff in financial services firms and for directors of listed companies, respectively.³

¹ European Commission Press Release: Charles McCreevy European Commissioner for Internal Market and Services Press Conference on Financial Package (29th April 2009), <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/206&format=HTML&aged=0&language=EN&guiLanguage=en>.

² European Commission Proposal for a Directive on Alternative Investment Fund Managers (30th April 2009), http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf and the accompanying Impact Assessment, http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_impact_assessment.pdf.

³ European Commission Recommendation on Remuneration Policies in the Financial Services Sector (29th April 2009), http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf and the related Frequently Asked Questions, <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/212&format=HTML&aged=0&language=EN&guiLanguage=en> and European Commission Recommendation Complementing Recommendations 2004/913/EC and 2005/162/EC as regards the Regime for the Remuneration of Directors of Listed Companies (29th April 2009), http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf and the related Frequently Asked Questions, <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/213&format=HTML&aged=0&language=EN&guiLanguage=en>. See also, European Commission Press Release: Financial services sector pay: Commission sets out principles on remuneration of risk-taking staff in financial institutions (29th April 2009), <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/674&format=HTML&aged=0&language=EN&guiLanguage=en>.

European Commission's Communication on Packaged Retail Investment Products (29th April 2009)⁴

On 30th April 2009, the Commission published a Communication (the "EC Communication") on PRIPs, together with a related Impact Assessment and Executive Summary of the Impact Assessment. On 29th April 2009, it published a press release and frequently asked questions ("FAQs") outlining its proposals to improve investor protection measures in respect of PRIPs.⁵

PRIPs are inherently diverse and include investment funds (including UCITS products), insurance-based investments, retail structured products and structured term deposits. Regulators believe that PRIPs raise greater concerns regarding product transparency (i.e., information disclosure, particularly as to their risks and costs) and the sales process.

The outbreak of the credit crisis in mid-2007 engendered renewed urgency in the Commission's review of the legal framework governing PRIPs in the EU, in particular, the risks to retail investors resulting from variations in EU rules on product disclosure and selling practices. Thus, the Commission had issued on 26th October 2007 a call for evidence on the "Need for a Coherent Approach to Product Transparency and Distribution Requirements for Retail Investment Products?"⁶ (acting in response to ECOFIN request in May 2007).

Based on this work, the Commission has concluded that the current EU framework was a "highly fragmented, regulatory patchwork," in that there is currently no coherent approach to investor protection standards in respect of the many legal forms of PRIPs and that the inconsistencies act as a barrier to informed decision making by investors in PRIPs.

Therefore, the Commission intends to introduce a "horizontal" legislative approach to provide a coherent basis for the regulation of mandatory disclosures (particularly disclosures relating to risks and costs) and selling practices at the European level.

Enhanced disclosures and product transparency

The objective is to achieve a highly harmonised standard of disclosures that will be applied to all manufacturers of PRIPs, regardless of the legal form that the products may take.

The following are the guiding principles in designing the (mandatory) key investor disclosures, which:

- should be "fair, clear and not misleading" and "comprehensible to their target investors;"
- should contain the information necessary to enable an "informed investment decision" in as much of a "standardised fashion that promotes comparisons between the products;"
- should be presented "in a format appropriate to a retail investor;"

⁴ European Commission Communication on Packaged Retail Investment Products (29th April 2009), http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/29042009_communication_en.pdf and the accompanying Impact Assessment, http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/29042009_impact_assessment_en.pdf.

⁵ European Commission Press Release - Financial services: Commission proposes better investor protection measures for Packaged Retail Investment Products (29th April 2009), <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/666&type=HTML&aged=0&language=EN&guiLanguage=en> and Communication on Packaged Retail Investment Products (PRIPs): Frequently Asked Questions (29th April 2009), <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/210&format=HTML&aged=0&language=EN&guiLanguage=en>.

⁶ European Commission Call for Evidence: "Need for a Coherent Approach to Product Transparency and Distribution Requirements for Retail Investment Products?" (26th October 2007), http://ec.europa.eu/internal_market/finances/docs/cross-sector/call_en.pdf.

- should be provided in a timely fashion; and
- should be clearly distinguished from any associated marketing communications (which should also be fair, clear and not misleading).

All those who sell PRIPs (i.e., both the intermediaries and the manufacturers selling their own products) should be required to provide investors with the mandatory disclosures produced by the product manufacturer, regardless of whether they provide any related service (e.g., advice or transmission of orders).

UCITS IV and the Key Information Document

Parallel to its review of the EU PRIPs regime, the Commission had also been undertaking since 2005 an extensive review of the EU framework for retail investment funds, including undertakings for collective investment in transferable securities (“UCITS”). As a result of this work, the new UCITS directive (“UCITS IV”) was adopted by the EU Council on 22nd June 2009 and published in the Official Journal on 17th November 2009.

Under UCITS IV, the Commission has proposed to replace the current Simplified Prospectus with a shorter, simpler and more easily understandable Key Information Document (“KID”).⁷ The Commission intends to use the UCITS IV requirements for KID contents as a benchmark in developing improved disclosure standards for the whole of the PRIP markets.

In connection with its application in PRIPs, however, the Commission recognises that the requirements of KIDs under UCITS IV are highly specific to UCITS and, therefore, will require substantial modification before a cross-product format can be produced. Due to significant differences in product features among the diverse range of PRIPs, a “one size fits all” approach would not be possible.

Other relevant work by the Commission includes the requirement to provide pre-contractual information for consumer credit customers in the form of a proposed “Standard European Consumer Credit Information” sheet under the Consumer Credit Directive.⁸

Improved selling practices and better investor protection

The Commission has identified a number of inconsistencies in the standards for sales practices for PRIPs under the existing sectoral legislation, such as the Markets in Financial Instruments Directive (“MiFID”)⁹ and the Insurance Mediation Directive (“IMD”).¹⁰

For example:

- Whereas MiFID contains detailed provisions on the payment of inducements to intermediaries as well as the prevention, management and disclosure of conflicts of interest, IMD does not. (Cf. IMD requires insurance intermediaries to tell customers whether they are giving advice based on a fair and sufficiently

⁷ See CESR Consultation Paper on Technical Issues relating to Key Information Document (KID) Disclosures for UCITS (16th March 2009), <http://www.cesr.eu/popup2.php?id=5643>. See also, CESR Advice to the European Commission on the Content and Form of Key Information Document Disclosures for UCITS (15th February 2008), <http://www.cesr.eu/popup2.php?id=4955>, and CESR Consultation Paper on Content and Form of Key Investor Information Disclosures for UCITS (16th October 2007), <http://www.cesr.eu.org/popup2.php?id=4814>.

⁸ EU Consumer Credit Directive (87/102/EEC), <http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1987/L/01987L0102-19900301-en.pdf>.

⁹ EU Markets in Financial Instruments Directive (2004/39/EC), http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l_145/l_14520040430en00010044.pdf.

¹⁰ EU Insurance Mediation Directive (2002/92/EC), http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l_009/l_00920030115en00030010.pdf.

wide ranging analysis of alternative products and whether they are under any contractual obligations to deal with one or more insurers.)

- Some PRIPs and distribution channels are not covered by either MiFID or IMD.
- Direct sales by product manufacturers (e.g., fund managers or product companies) are not subject to the same disciplines as sales by intermediaries.
- There are no European rules on the distribution of structure term deposits (which are not included in the MiFID definition of “financial instruments”).

The Commission intends to develop more “horizontal” standards as to conduct of business, inducements and conflict of interest provisions, to be applied consistently to all those who sell PRIPs, with MiFID serving as the benchmark for PRIPs selling practices.

In this regard, the key challenges would be the need to provide a sufficiently clear legal definition for PRIPs as well as a consistent framework for the disclosure of fees and charges and the potential risks and rewards despite the wide diversity of PRIPs and their underlying investments.

In due course, the new measures will repeal and replace certain existing measures to avoid imposing overlapping requirements.

The Commission has stated that the following will be the guiding principles concerning the regulatory framework to be developed for the selling practices to be applied consistently across the PRIP markets:

- The selling process must be “focused on the fair treatment of the investor.”
- When giving investment advice, the advisor must ensure (i) that the product corresponds to the investor’s profile and needs and (ii) that the investor understands the nature of the service being provided.
- Where the product is sold without advice (“non-advised sale”), the seller of the PRIP should clearly communicate the limits to its service and the risks.
- In all sales (i.e., both advised and non-advised sales), conflicts of interest must be avoided, managed and disclosed in a manner which the investor can understand.
- In all sales, all fees, charges or commissions and the remuneration arrangements must be disclosed clearly and effectively, in a form the investors can use.
- Those assessing “suitability” must have full understanding of the product and its features.

Joint Association Committee’s feedback on the Commission’s PRIPs proposals¹¹

In a letter to the Commission dated 17th November 2009, the Joint Association Committee (“JAC”) strongly petitioned the Commission that the definition of PRIPs should not be based on the product’s legal form but rather on its economic characteristics. To do otherwise would expose the framework to regulatory arbitrage (such as avoidance through repackaging) whilst adding significant extra costs by unnecessarily bringing wholesale products within the scope, without any resulting improvement in retail investor protection.

In addition, whilst agreeing that the KID under the new UCITS IV Directive and the suitability and appropriateness tests under MiFID should be used as benchmarks in formulating the new EU legal framework for PRIPs, the JAC advised that it should be possible to tailor the KIDs to particular products as well as individual clients or customers.

¹¹ [Joint Association Committee’s feedback letter to the Commission on the PRIPs proposals \(17th November 2009\).](http://www.isda.org/c_and_a/pdf/PRIPS_JAC_Response_Updated.pdf)

ECOFIN Conclusions on PRIPs (9th June 2009)¹²

On 9th June 2009, the EU Economic & Financial Affairs Council (“ECOFIN”) published its conclusions on PRIPs (9th June 2009), which welcomed and expressed support for the Commission Communication.

In its conclusions, ECOFIN particularly welcomed the Commission’s intention to introduce a horizontal legislative approach to the treatment of disclosure and selling practices. In view of the important role which PRIPs play in the retail markets, ECOFIN agreed that the regulatory framework for PRIPs must provide a robust and coherent regulatory environment for the sale and disclosures of PRIPs in order to restore confidence in the financial markets.

ECOFIN also welcomed the Commission Study on Credit Intermediaries in the Internal Market published on 13th May 2009,¹³ and called for a further review of whether the distribution of other substitute retail financial products and retail credit instruments (e.g., consumer credit and mortgages) should be covered by further regulatory measures.

Update on Commission work on Packaged Retail Investment Products (16th December 2009)¹⁴

On 22nd October 2009, the Commission hosted a Technical Workshop on PRIPs in Brussels and published the related (i) Issues Paper: “Packaged Retail Investment Products: Issues for discussion;” and (ii) minutes: “Summary of Technical Workshop on Packaged Retail Investment Products.”¹⁵

The workshop provided a valuable opportunity to collect technical input on the Commission’s April 2009 proposals from market participants, and was attended also by key EU financial regulators, including the Committee of European Securities Regulators (“CESR”), the Committee of European Insurance and Occupational Pensions Supervisors (“CEIOPS”) and the Committee of European Banking Supervisors (“CEBS”).

On 16th December 2009, the Commission published a working paper to update the public concerning its ongoing work on PRIPs. Drawing upon feedback from such stakeholders as CESR, CEBS and CEIOPS, the Commission outlined the “emerging” approaches to its April 2009 proposals, which are becoming more and more clearly delineated.

Some preliminary conclusions could now be drawn as to the likely shape of the legislative proposals in the works:

¹² ECOFIN Conclusions on Packaged Retail Investment Products (9th June 2009), http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/108385.pdf. See also (and more broadly), ECOFIN Conclusions on Strengthening EU Financial Supervision (9th June 2009), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/108389.pdf.

¹³ European Commission Study on Credit Intermediaries in the Internal Market (by Europe Economics, 13th May 2009), http://ec.europa.eu/internal_market/finances-retail/docs/credit/credit_intermediaries_report_en.pdf.

¹⁴ European Commission Update on Commission work on Packaged Retail Investment Products (16th December 2009), http://ec.europa.eu/internal_market/finances-retail/docs/investment_products/20091215_prips_en.pdf

¹⁵ 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/finances-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/finances-retail/docs/investment_products/minutes-prips-workshop-221009_en.pdf.

Area	Preliminary Conclusions
Scope (i.e., definition of PRIPs)	PRIPs must be defined based on economic criteria. The scope should capture the core market for PRIPs where the investors bear a high degree of investment risk.
	As outlined in the Issues Paper, each of the three criteria must be satisfied, i.e., the product must: <ul style="list-style-type: none"> i) involve an element of packaging; ii) be capable of meeting investor’s need for capital accumulation; and iii) create exposure to investment risk for the investor.
	Further technical work is necessary to define the precise details. However, to achieve greater consistency and comparability among PRIPs (particularly in pre-contractual disclosure), the Commission is inclined to exclude direct investments in simple “plain” assets, e.g., pure shares or bonds, commodities or property. Unit- or index-linked insurance-based investment products should, however, be included.
	Further work and analysis is needed on the treatment of pensions and annuities
Pre- contractual disclosures	The disclosure framework should be applied cross-sectorally, with both common and tailored requirements.
	Framework should include requirements on the use of plain language and document length.
	Content requirements for KIDs should be subject to consumer testing, to fully reflect investors’ needs.
	To help investors compare different products, the common elements should include: <ul style="list-style-type: none"> i) the document structure, ii) order of sections, iii) use of plain language, and iv) focus on key information about the nature of the product, its risks, potential performance and costs.
	Detailed requirements are needed to support the standardisation of such elements as common risk, cost and performance metrics.
	Some tailoring of disclosure requirements is necessary to better protect investors.
	Two possible options are being considered as to who has the responsibility for preparation of KIDs: <ul style="list-style-type: none"> 1) <i>Option 1:</i> Detailed rules placing the responsibility on the product originator in general, but also on the distributors given their role in bringing certain PRIPs into the retail market. 2) <i>Option 2:</i> A more flexible approach relying on the cooperation between the product originator and the distributor.
Seller has responsibility for delivery of the disclosure document.	
Selling practices	The same overall framework and high-level principles should be applied to all sales of PRIPs, regardless of the particular legal form or the distribution channel.
	Generally, the same detailed requirements on conflicts of interest, inducements, appropriateness, suitability and related disclosures should be applied to all sales of PRIPs. However, some tailoring may be necessary to reflect different distribution arrangements.
	Further refinement is likely to be necessary to better protect investors.

Next steps – Detailed legislative proposals

The Commission is currently working on detailed legislative proposals, which involves:

- collecting technical input from Member State authorities, technical committees and other stakeholders;
- conducting studies to inform the preparation of legislative measures; and
- publishing an initial outline of the form and content of legislative measures in the next few months, for public consultation.

The Commission should be publishing an outline of those proposals for public consultation in the forthcoming months.

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