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Will the PRIPs' KID live up to its promise to protect investors?

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On July 3rd, the European Commission unveiled its long-awaited proposal to improve the information that investors receive before purchasing a wide range of packaged retail investment products (PRIPs).[1] This so-called 'PRIPs initiative' represents a key step in enhancing the protection of retail investors and advancing the single market for financial services. Under the Regulation, every potential investor would receive, at the point of sale and free of charge, a short 'key information document' (KID) presenting the essential characteristics of the product in plain language.

The field of application of the KID is vast and encompasses *investment funds*, both open-ended and closed, including UCITS but also AIFs sold to retail investors; *unit-linked insurance products*, i.e. insurance policies whose underlying asset is an investment unit; and all sorts of *structured products*, whether packaged by banks, insurers or other agents (Art. 2).

What will the KID look like?

In short, a KID will be required for all investment products that entail: i) investment risk for the buyer, meaning the payout of the product depends on the market value of given assets, and ii) 'packaging', meaning that the assets are not held directly by the investor but rather are the underlying or reference assets to the end product. The KID will therefore not apply to plain-vanilla securities and bonds but to the products that 'wrap' those in one way or another. It is this element of 'packaging' that adds a further layer of complexity and justifies a higher standard of disclosure, not only in terms of risks but also in terms of costs.

Covered by the PRIPs initiative	Not covered by the PRIPs initiative
– Investment funds (open-ended/closed; UCITS/AIFs) – Insurance policies whose surrender values are exposed to market fluctuations (e.g. unit-linked insurance policies) – Structured products manufactured or sold by banks – Products with capital/return guarantees (e.g. structured-term deposits) – Other structured products (e.g. structured investment funds) – Individual pension products – Securities that embed a derivative	– Investment products sold to institutional investors (e.g. professional AIFs) – Investment products with no packaging (e.g. plain vanilla securities and bonds, under the Prospectus Directive) – Traditional deposits – Non-life insurance products and protection insurance products – Occupational pension schemes under Directive 2003/41/EC – Pension products for which a financial contribution from the employer is required and where the employee has no choice as to the provider

The KID standard will be similar to the UCITS' KIID (key investor information document) but re-formulated to accommodate the diverse range of products that qualify as PRIPs. The objective of the KID is two-fold: i) to allow a comparison between products within the same category, for instance between fund A and fund B, and ii) to allow a comparison between different categories of products, for instance between fund A and insurance policy C. The document will give clear

[1] Proposal for a Regulation on Key Information Documents for Investment Products, COM (2012) 352/0169.

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answers to pertinent questions such as: What is this investment? What are the risks and what might I get back? What are the costs? Responses to these questions are to be spelled out under separate headings (Art. 8).

The KID will help consolidate the single market for financial services. It does not equal a marketing passport but the document will be fully harmonised and valid across the Union – under a regulation rather than a directive. It will just need to be translated into the local language of each member state where it is marketed. Currently, pre-contractual disclosure is not harmonised in the EU except for UCITS funds. Some member states have acted to fill this vacuum and ensure investor protection but others have failed to do so. This patchwork fragments the single market and makes competition among product providers more difficult, resulting in higher costs for investors.

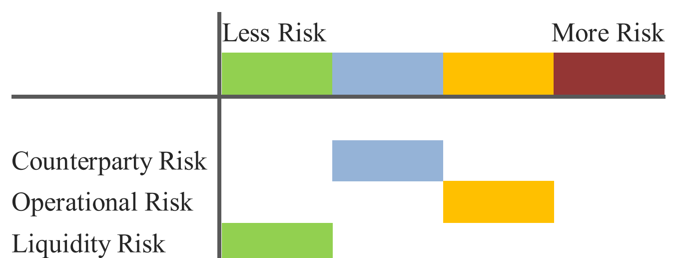
At first sight, the KID proposal may look rather straightforward, but its complexity in practice should not be underestimated. It will require a fair amount of work by the Commission and ESMA to develop and enforce the full set of implementing acts and technical standards needed to put flesh on the KID. In particular, ensuring comparability across widely different product categories may turn out to be more difficult than initially envisaged, if disclosure is to be meaningful and not misguiding. Ill-devised disclosure could end up pushing investors towards certain product categories instead of others. Such an outcome could be potentially harmful for the individual investor but also entail unintended effects for financial stability and the financing of the real economy.

What about non-conventional risks?

To provide meaningful information to investors, it is very important to emphasize the disclosure of non-conventional risks, also called non-market risks, such as operational, counterparty and liquidity risks. Focusing solely on market risks may misrepresent the real risk in most investment products. Both the PRIPs KID proposal and the UCITS' KIID are disappointing in this respect.[2] The insufficient attention paid by regulators to non-conventional risks may well be explained by the difficulty in measuring or otherwise representing them. Market risks are easier to express in numbers – although standard metrics are based on past performance and usually underestimate the probability of exceptional market circumstances, when hidden non-market risks become the most relevant.

The KID will feature warnings in relation to specific non-conventional risks (Art. 8.2.e). But for such warnings to be meaningful, thorough work will be needed to categorise such specific risks in practice and devise the standard warnings. The regulatory process will need to go beyond the statement of high-level principles to ensure meaningful disclosure in practice. At the same time, warnings about specific risks may be of little help to investors attempting to make comparisons across different products, let alone across different product categories. Such comparability can be achieved via some form of graphic presentation of disclosure – similar to the illustrative chart below. An alternative proposal has been to capture the level of non-market risks in the form of a rating.

Example of graphical disclosure of non-market risks



Where market risks are transformed and repackaged, resulting in novel operational, counterparty or liquidity risks, it is crucial to clearly communicate these non-conventional risks to investors. Otherwise, they may be lured into more complex products that may possibly exhibit a smoother pattern of returns but also carry hidden risks that later materialise, in stark contrast with investor expectations. At the same time, failure to communicate non-market risks to investors may privilege products based on complex derivatives and structured financial instruments that increase the interconnectedness and complexity of the overall financial system, to the detriment of financial stability.

An ambitious but challenging proposal?

Beyond non-conventional risks, the KID proposal is ambitious when it comes to the content of disclosure. It is worth noting the emphasis on disclosing two respects: the *recommended minimum holding period* and the *liquidity profile* of the product (Art. 8.2.d). Information on these two aspects is rather lacking in the UCITS' KIID, probably due to the legal requirement for UCITS to be highly liquid and repurchase or redeem units at the request of investors (Art. 84, Directive 2009/65/EC).[3] Investment horizons,

[2] It should be noted that Art. 8.5 of the UCITS KIID Regulation (583/2010) requires the disclosure (in a narrative form) of any specific credit, liquidity, counterparty and operational risks, as well as the impact of using derivatives on the risk profile. However, there is no specific implementation or guidance in this respect. It is uncertain to what extent this disclosure takes place in practice.

[3] UCITS managers are obliged to warn investors that "this fund may not be appropriate to investors who plan to withdraw their money within [period of time]" *only* if they consider a minimum holding period is an essential element of the investment strategy (Art. 7.2.f, Regulation 583/2010). The PRIPs' KID should avoid using such negative phrasing, which may misrepresent to investors the importance of

however, are an essential element in any investment decision. It has been argued extensively that very liquid products may not always be in the best interest of investors.[4]

The UCITS' KIID was introduced for new funds in July 2011 and for all existing funds in July 2012. The European Commission has therefore deemed appropriate to award a grace period to UCITS managers who will not need to produce the PRIPs' KID during the first five years after the adoption of the KID Regulation. While it is sensible to delay the introduction of the KID for UCITS who just produced their KIID, it undermines the essential objective of the PRIPs initiative, namely to allow comparability across different product categories. The two aspects mentioned above, holding periods and liquidity profiles, are just examples of key information that investors will not be able to compare. It would be sensible to introduce the KID earlier for new UCITS funds. After the five-year transition period, the UCITS' KIID should disappear and all pre-contractual disclosure should fall under the same piece of legislation – it is worrying that the Commission is not certain about following this path.[5]

Further evidence of ambition in the PRIPs proposal is the space reserved in the KID for *responsible investment products* to be featured as such. It envisages the summary disclosure of the specific environmental, social or governance (ESG) objectives and the means to achieve them (Art. 8.2.b.iii). The idea is laudable but, once more, it will demand thorough work from regulators and supervisors to make sure ESG branding is not used as a mere marketing tool. Harmonising pre-contractual disclosure before creating an EU framework for responsible investment products may not work well in practice.

Overall, the KID is a good proposal but pre-contractual disclosure is just one of the pieces in the jigsaw puzzle of investor protection. The Commission points out that it should be read alongside the reform of selling practices in MIFID and the IMD. Regrettably, the proposals have been far less ambitious in this latter respect – and risk being furthered watered down by the European Parliament. It somehow looks as if the EU will place all the eggs of investor protection in the basket of pre-contractual disclosure. It simply will not work.

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investment horizons. Disclosure of this essential element should be phrased proactively in all instances.

[4] See Mirzha de Manuel Aramendía and Karel Lannoo, *Rethinking Asset Management: From Financial Stability to Investor Protection and Economic Growth*, ECMI-CEPS Task Force Report, April 2012 (http://www.ceps.eu/book/rethinking-asset-management-financial-stability-investor-protection-and-economic-growth).

[5] The European Commission envisages at least two possibilities after the five-year transition period: i) maintain the UCITS' KIID, perhaps aligning it with thePRIPs' KID or ii) repealing the UCITS' KIID, subjecting UCITS toPRIPs' KID, and possibly reforming the PRIPs' KID (see p. 10 of the Explanatory Memorandum to the PRIPs' KID proposal).