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Dear Sirs,

PRIIPS regulation – significant matters requiring clarification

The Joint Associations Committee (“JAC”) has, on behalf of its members, raised some material concerns in relation to the PRIIPs Regulation in terms of interpretation and implementation issues. These have been highlighted in various letters sent from the JAC to the European Commission and the European Supervisory Authorities (“ESAs”) which are set out in Appendix 1.

We thank the European Commission for its response to our letter of 17 February 2016 (the “Commission Response”) and the positive offer to work with our industry and accordingly we are writing to suggest how certain material issues might be resolved through the Level 3 guidance that we understand the ESAs are currently drafting for publication in mid-May. We have suggested a formulation for the Q&A which we hope is helpful drawing on the Commission Response as well as the commentary in the 11 July 2016 workshop in Brussels (the “Brussels Workshop”) accessible [here](#). We welcome any opportunity to engage with you on behalf of our industry to discuss a useful and pragmatic way forward in order that firms can successfully plan and implement this legislation by January 2018.

This letter covers general issues around the applicability of the PRIIPs Regulation to OTC derivatives and also covers the following points:

1. FX forwards in deliverable currencies
2. OTC derivatives – indicative KID
3. Secondary trading and grandfathering
4. Territorial scope
5. Discretionary mandates
6. Gold plating

The JAC would, in particular, like to highlight the position in relation to OTC derivatives sold to retail investors. A significant number of OTC derivatives (for example, FX forwards) will be entered into by a wide variety of commercial entities mainly for hedging purposes: municipalities, local authorities and many commercial companies. There is a significant risk that by extending the PRIIPs Regulation to include instruments such as FX forwards (which should not fall within the scope of the PRIIPs Regulation, please see the below reasoning), the proper functioning of these markets could be significantly affected which potentially increases the financial risks to such entities of doing business in Europe and is in direct contradiction to certain objectives of the Capital Markets Union where financial markets should contribute to financial growth and stability, not constrain it. We note that this issue is of pan-European importance and understand it is being considered by regulators in a number of Member States.

The JAC would particularly wish to highlight that the wording currently prescribed for use in a KID by the RTS fails to reflect the nature of OTC derivatives transactions or accurately describe their risks or rewards. OTC derivatives are not investment products in the “conventional” meaning under which a retail investor invests a certain amount at the beginning of the OTC derivative’s term and receives an amount on its maturity. Instead, payments under the OTC derivative are normally made during the term of the product. We would note the following examples where the wording in the RTS is not appropriate for an OTC derivative KID:

- Annex III: Presentation of SRI – the references to “cash in early” and being able to “sell” early are not applicable to an OTC derivative contract under whose terms counterparties are generally bound until the scheduled termination date. No investment is made under the contract which is capable of being cashed in early and derivatives are not capable of being sold in the way that securities are.
- Annex V – Performance scenarios – references to “amounts invested” are equally inappropriate in the context of an OTC derivative since counterparties do not make any investment by entering into such transactions. As above, “cashing in early” is not an appropriate phrase in relation to such transactions. Counterparties should instead be referred to the requirement to exchange payments under the transactions and the possible mark-to-market gains or losses upon early termination or through the life of the transaction (including that the mark-to-market of the swap may be significantly against them even if rates are currently in their favour because the value of a swap incorporates consideration of potential future market movements).
- Annex VII – Costs – references to cumulative costs for “three different holding periods” are not appropriate to OTC derivatives transactions where counterparties are generally bound until the scheduled termination date. This may, therefore, give the retail investor a misleading impression that there is an early termination right which is generally not the case for OTC derivatives.
- Where the OTC derivative is collateralised, the concept of a “PRIIP holding possible obligation to add to initial investment” does not accurately convey that counterparties may be subject to margin calls which will be based on the assessment of the value, not just of current payment obligations, but all future obligations as well. This may mean that counterparties have to make payments (which are not investments) which are significantly in excess of their individual periodic payment obligations.

The JAC is concerned that market participants may feel forced to take one of the following courses of action:

Option 1: Depart from the prescribed language, where that prescribed language is incorrect or misleading. The potential issue with this approach is that if the KID is not in compliance with the PRIIPs Regulation obligation to include the prescribed language in the form and with the wording as set out in the RTS; such firms would be potentially subject to regulatory action for breach.

Option 2: Retain the prescribed wording but use the freeform text to attempt to translate the prescribed wording into the context of an OTC derivative relationship. For example, wording is included in the 'What is this product?' section set out in Article 2 of the RTS. In this case, the KID might then be confusing for investors and, as such, may not comply with the obligation to be accurate, fair, clear and not misleading.

Option 3: Prepare a supplemental pro-forma document that seeks to explain the contents of the KID in the context of an OTC derivative transaction. As noted above, the KID might then be confusing for investors and, as such, may not comply with the obligation to be accurate, fair, clear and not misleading.

Without the technical language in the RTS being corrected or allowing deviation from the technical language in the RTS, we are concerned that firms may feel compelled to stop trading OTC derivatives with retail investors (including a wide variety of commercial entities: municipalities, local authorities and any commercial companies).

In addition, we would raise the following specific points:

1. FX forwards in deliverable currencies

In the case of an FX forward contract, the currency exchange rate payable at a future date is locked in at the outset of the agreement with the retail investor. The definition of "PRIIP" in Article 4(1) of the PRIIPs Regulation, states that the amount repayable fluctuates over the lifespan of the agreement. This definition would not therefore be met in relation to an FX forward contract. A similar analysis would apply to other derivatives whose value is set at the trade date (including, for example, commodity forwards).

Furthermore, an FX forward is not an alternative way of gaining the same exposure as would be acquired by purchasing the underlying asset (i.e. the foreign currency) directly by the retail investor. It is an agreement which may remove the risk of exchange rate fluctuations over a pre-defined term. We provided a specific example of such a transaction in our letter dated 23 June 2016 and we noted that certain FX forwards which are either spot or relate to certain payment obligations in specified circumstances would not be financial instruments for the purposes of MIFID2.

We note that the Commission Response states that any investment product to which the retail investor gains exposure to assets that he is not directly acquiring should be caught by the PRIIPs Regulation unless explicitly exempted and the JAC would, as such, request a specific exemption. However, we understand that under Article 4(1) of the PRIIPs Regulation there must be an element of fluctuation in any relevant exposure for a product to be caught, and in an FX forward situation there is not.

FAQ requested:

Question: Are FX forwards within scope of the PRIIPs Regulation?

Answer: FX forwards (and certain other instruments - interest rate swaps, cross currency swaps and zero cost collars transactions where payments are fully known at the outset of the transaction), where the currency exchange rate payable at a future date is locked in at the outset of the agreement with the retail investor and where the amount repayable will not fluctuate over the lifespan of the agreement should not be within scope of the PRIIPs Regulation. FX forwards (and such other instruments) are not investments where the amount repayable fluctuates because of exposure to assets which are not directly purchased by the retail investor.

2. OTC derivatives – indicative KID

We request the Commission and the ESAs to take into account our opening remarks around OTC derivatives on page 2 of this letter, but we have also set out below a proposed solution to some additional issues around OTC derivatives.

The Commission Response to the JAC stated that the PRIIPs Regulation does not make any distinction in relation to the product's intended purpose, such as, for investment, risk management or hedging purposes and, therefore, that KIDs will be required for OTC derivatives but that the Commission would closely co-operate with the ESAs to ensure that guidance is provided as soon as possible to take into account the OTC derivative's nature. We stated in our letter dated 23 June 2016 our belief that generic/standardised KIDs should be permitted for certain OTC derivatives.

We note that the RTS does not explicitly permit “generic” KIDs to be prepared for OTC derivatives; however, Recital 4 of the RTS provides that the KID “should contain standardised information”. It was suggested during the Brussels Workshop (and indicated in the related presentations) that standardised KIDs would be permissible. As such, the KID should not be required to include individual trade specific information. We would, therefore, propose that for OTC derivatives, a standardised KID with indicative parameters is permitted which complies with the format as set forth in the RTS and provides indicative information by reference to tenor, type of derivative and underlying. This would allow a standardised KID to be delivered to retail investors in good time before they make their investment decision whilst at the same time addressing the following issues:

- the granular and individual details of the underlying trade will only be known once the trade is placed, which will be after the product is “distributed” to the retail investor;
- in respect of FX, the speed of movement of the FX markets and the best execution obligations constitute a significant impediment to production of a trade specific KID.

FAQ requested:

Question: May an indicative KID be prepared for an OTC derivative transaction?

Answer: The use of a standardised KID with indicative parameters is possible for OTC derivatives concluded by way of a bilateral contract with retail investors and that in relation to the performance scenarios section of the KID, OTC derivatives may be presented in the same way as exchange traded derivatives. Provided that the retail investor is informed of the final details of the transaction by way of other trade specific documentation (e.g. a confirmation), there is no requirement to update the KID once the final details are known.

3. Secondary trading and Grandfathering

The JAC has previously raised the issue that PRIIPs traded in the secondary market should not automatically be regarded as being ‘made available to retail investors’. We are of the view that ‘made available’ should be interpreted within its literal meaning, i.e. somebody actively ‘makes a product available for sale’ by allowing retail investor to purchase it after a (usually closed) initial offering period.

The Commission Response stated that the PRIIPs Regulation does not provide any grandfathering and therefore all PRIIPs offered to retail investors from January 2018 would need to have a KID. We note the Commission Response position in relation to existing PRIIPs (i.e. PRIIPs offered prior to the application date of the PRIIPs Regulation and that are traded on the secondary market). We also welcome the acknowledgment in the Commission Response of the challenges in implementing the PRIIPs Regulation in this respect and the offer to work with our industry to provide additional clarity.

The learning from the Brussels Workshop provided helpful examples of where the manufacturer’s KID obligation ceases including:

- When the retail investors cannot buy the product or enter the contract any longer;
- Manufacturers offer price for redemption only; and/or
- Closed books of business.

We would ask for clarification around whether a KID should be required for a product where information cannot be accurately sourced on a retrospective basis, on the condition that the manufacturer commits not to make these existing products available to retail investors. The financial consequences of preparing, producing and maintaining KIDs for all existing products would be significant. In addition, manufacturers may not be able to source accurate historical data (for instance data about costs or past performance). PRIIPs manufactured and sold prior to 31 December 2017 where past information cannot be accurately sourced on a retrospective basis should not be deemed to be made available to retail investors.

FAQ requested:

Question: A manufacturer is required to draw up a KID before a PRIIP is “made available” to retail investors. What is the meaning of “made available” in this context?

Answer: A KID should be “made available” where products are either:

- in their public offer period (and this should be tied in to the definition in the Prospectus Directive (“PD”)); or

- actively marketed to a retail investor by the manufacturer or a distributor with the manufacturer's consent or acquiescence.

The existence of a secondary market independent of the manufacturer in respect of an existing product does not constitute making a product available to retail investors irrespective of the initial offering date being prior to or following the commencement date of the PRIIPs Regulation. Specifically, where a manufacturer only provides a "bid" price for redemption by the retail investor (for example, where the PRIIP has been privately placed through a private bank to a retail investor with limited on-sale opportunities), a KID is not required to be reviewed or updated and the manufacturer's obligations will cease.

4. Territorial scope

The Commission Response (and the commentary from the Brussels Workshop) stated that where a PRIIP is offered to non-EU retail investors by a European manufacturer via an intermediary established in a non-EU country, the obligations of the PRIIPs Regulation do not apply. The Regulation will only apply to PRIIPs offered to retail investors domiciled in EEA countries.

FAQ requested:

Question: Does a KID need to be drawn up or provided to a non-EEA retail investor?

Answer: The provisions of Article 5 and Article 13 of the PRIIPs Regulation will only apply where the retail investors to whom the PRIIP is made available are present in a member state at the time at which the PRIIP is made available to them. As such, a KID does not need to be made available or provided to a non-EEA retail client.

5. Discretionary mandates

We note that representatives of the European Commission and the ESAs at the Brussels Workshop (and the follow up slides at Slide 2) stated that where discretionary investment managers transact in PRIIPs in the name and for the account of a retail investor, there is no requirement to provide the discretionary manager or the retail investor with a KID.

FAQ requested:

Question: Is a KID required to be provided where the PRIIP is sold to a discretionary investment manager or a discretionary investment manager is transacting in the PRIIP in the name and for the account of a retail investor?

Answer: No, where a PRIIP is sold to a discretionary investment manager or a discretionary investment manager is transacting in the PRIIP in the name and for the account of a retail investor, a KID is not required to be drawn up and published by the manufacturer or provided by the distributor. A KID does not need to be drawn up or provided in this scenario on the basis that (i) the discretionary manager is not a "retail investor" under Article 4(6) of the PRIIPs Regulation and as such should be able to fully comprehend the relevant product features; and (ii) the purpose of the PRIIPs Regulation is to enable a retail investor to make an informed investment decision; however, in the context of a discretionary management relationship, the discretionary manager makes the investment decision on behalf of the retail investor.

6. Gold plating

The JAC understand that a number of national competent authorities ("NCAs") are contemplating "gold plating" KID requirements by their own interpretation of certain provisions and mandating specific content into the KID in their jurisdictions. NCAs are of course free to impose retail customer protection measures in their jurisdictions which go beyond EU minima. However, we believe that consistency is required so that the scope and form of the KID itself remains comparable across member states. It is an essential element of the creation of a single EU retail product market that the core customer information document and interpretation on scope should be the same across the EU.

This is particularly important because the PRIIPs Regulation has no provision clarifying which NCA will have jurisdiction over a KID or indeed if multiple NCAs might have jurisdiction over the same KID (e.g. the NCA of the manufacturer and the NCAs of each jurisdiction in which the PRIIP is made available to retail investors). To the extent that the NCA jurisdiction point is not clarified (and in particular where gold plating is permitted) a manufacturer may be left in the position of needing to prepare multiple KIDs for the same

product to reflect NCAs' differing requirements, which would clearly be contrary to the purpose of the PRIIPs Regulation.

FAQ requested: A clear statement from the ESAs that gold plating of the PRIIPs KID content requirements is not appropriate.

Yours faithfully



Mr. Alderman Timothy R. Hailes, JP

Alderman Tim Hailes, JP
Chairman, Joint Associations Committee