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29 October 2012

JAC Position Paper:

Draft regulation on key information documents for investment products

The Joint Associations Committee on Retail Structured Products (the **JAC**)[1] welcomes the publication by the Commission of the draft regulation on key information documents for investment products COM(2012) 352/3, 2012/0169 (COD) (the **Draft Regulation**) which forms part of the Commission's wider Packaged Retail Investments Products (**PRIPs**) initiative. As noted in our previous submissions to the Commission in relation to PRIPs and to CESR in relation to UCITS Key Investor Information (**KII**), we wholeheartedly support the broad aims of these initiatives and are confident that a well designed regime can deliver benefits for both consumers and the industry. We consider it essential that European investors can confidently access good quality investment products which they can use in seeking to meet their investment needs and that those products are distributed in a way that means they can be clearly understood and compared. Indeed, the JAC was originally established and has worked over some years to promote a co-ordinated industry approach to improving consumer outcomes, both within the EU and internationally. In particular, the JAC has worked with the industry to produce a set of good practice principles for managing the relationship between product providers and distributors and a further set of principles for managing the relationship between distributors and individuals which we would be happy to provide on request. In this light, we are keen to offer our continued assistance to the Commission, Council and Parliament in building a robust Level 1 framework for the PRIPs KII workstream.

We agree with many elements of the proposed framework set out in the Draft Regulation which envisages some clear improvements for consumers. There are, however, a number of significant qualifications from both a consumer benefit and an industry perspective. This paper seeks to highlight these issues, with the hope that this will be helpful in informing the policy debate and ensure the best possible outcome for consumers. We would be very happy to provide further input on any of the below points if that would be of assistance. Our previous detailed submissions to the Commission and ESMA in relation to KII are available at http://www2.isda.org/asset-classes/structured-products.

Unless otherwise stated, references to a numbered Article, relate to the corresponding Article of the Draft Regulation.

Timothy R Hailes
Chairman, Joint Associations Committee

[1] The members of the JAC comprise most of the major firms (both financial institutions and law firms) involved in the creation and to some extent distribution within the EU of structured securities which are distributed to retail investors. The exposures available through the securities may also be made available through all of the other product-types covered by the PRIPs initiative, including investment funds, insurance products and structured deposits. The PRIPs initiative is therefore of prime relevance to the members of the JAC and their position in the market gives them a unique perspective on it. In the first instance, queries may be addressed to Adam Jacobs (ajacobs@isda.org).

FEEDBACK

Our feedback below is informed by our understanding of the Commission's "Problem Definition"[2] and expressed objectives[3] for the PRIPs initiative. These objectives are to "*improve the quality of investor decision making and the functioning of EU capital markets*" by putting operational measures in place to:

- Improve comprehensibility of disclosures
- Improve comparability of products using disclosures
- Ensure disclosures are provided at the right time in the sales processes
- Improve regulatory consistency

The Commission's intention is that the implementation of the above measures will assist in tackling the perceived breakdown in confidence and trust in the retail market.

We agree that the introduction of a mandatory short-form disclosure regime may assist in these goals. However, the focus must be on ensuring that this document is designed to provide a high standard of summary disclosure, and does not inadvertently undermine other product literature which retail investors already find useful. Attempting to over-simplify product information, focusing on brevity at the expense of quality, and attempting to put disclosure into an inappropriate framework will severely limit the usefulness of the disclosure and is likely to result in the document misleading investors. Indeed, regulators in the UK have already taken disciplinary action against financial services firms for providing information in relation to complex products where the regulator determined that simple explanations had caused the disclosure to be misleading. The UK Financial Services Authority (**FSA**) found that the provision by firms of over-simplified information about complex financial products like PRIPs violated UK financial services rules and imposed significant financial penalties on the firms in question (please see details of this disciplinary action and some further considerations regarding issues related to summary disclosure in Annex 1 below).

Elements of the proposed regime run a very real risk of damaging (rather than improving) investors' understanding of the particular product in which they are about to invest their money. This will increase and not mitigate the risk of PRIPs being misunderstood by, and mis-sold to, investors.

It is also important to note that, as recognised in the Commission's consumer research and acknowledged in the Commission's Explanatory Memorandum published with the Draft Regulation (the **Explanatory Memorandum**), the key influencing factor on retail investors' decision making is the advice they receive at the point of sale. This advice is subject to comprehensive regulation under the Markets in Financial Instruments Directive (**MiFID**) (Directive 2004/39/EC)[4] and the Insurance Mediation Directive (Directive 2002/92/EC). The PRIPs Key Information Document (**KID**) may be of further assistance to them in making their decision, and as such will act as a further important risk mitigant against mis-selling of products. It will not be, cannot be, and should not be designed with the aspiration of being, a panacea to this problem. To do that, will necessarily compromise the quality of disclosure provided (and hence the utility of the document), again in contrast to the Commission's stated aims. Furthermore, we note that robust national and EU level regimes are already in place to regulate the fairness of terms and conditions in consumer contracts (for example, the Unfair Consumer Contract Terms Directive 93/13/EEC). The KID proposals must be considered in light of all of these relevant regimes.

We have divided our feedback into two sections:

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[2] as set out at p. 9 (the "Problem Tree") and pp. 10-25 of the Commission Staff Working Document: Impact Assessment (SWD(2012) 187 final (the **Impact Assessment**).

[3] as set out at pp.26-27 of the Impact Assessment.

[4] Under the MiFID regime (as amended) investors in "complex" products are already afforded a high degree of protection, including a requirement that such complex products must not be sold to retail investors on an unadvised basis. The MiFID II workstream in particular includes a number of significant new consumer protection provisions.

Section 1 provides analysis of the key issues raised by the proposed Level 1 Draft Regulation. This includes our specific suggestions for amendments required to the Draft Regulation to ensure a workable regime from an industry perspective.

Section 2 discusses significant elements of the regime that the Draft Regulation leaves to be clarified at Level 2, highlighting important points that will need to be considered as part of the Level 2 work.

SECTION 1. KEY ISSUES (Level 1)

SPEED READ

We have split the key issues into three categories (A, B and C). Category A issues are those that we consider have the potential to make the regime unworkable. Category B issues are those that we view as significant obstacles to the achievement of the Commission's expressed objectives. Category C issues relate to points that we believe need to be clarified in the Draft Regulation.

Key requirements to ensure a workable regime and that are not adequately addressed by the Draft Regulation are:

- The relationship between the KID and the product terms and conditions (see (a) below).

- The basis of civil liability for the KID should be conformed to that of the UCITS KII (see (b)(i) below).

- The civil liability regime should fit within the existing regulatory liability regimes which contain appropriate safeguards (see (b)(ii) below).

- The product manufacturer must be able to exercise control over the KID and should not be liable for any breach by a person selling its products without permission (see (b)(iii) below).

- A product manufacturer must not be liable for alterations of a product beyond its control (see (b)(iv) below).

- All the information required to be provided must be of a nature that the product manufacturer can take responsibility for (i.e. it must be within the product manufacturer's knowledge and control) (see (b)(v) below).

- The party responsible for disclosure must be given sufficient space in the document to satisfy the disclosure requirements (see (b)(vi) below).

- A KID should only be required to be up to date at the point when an offer or sale is made (see (b)(vii) below).

Addressing these points will be important to create a workable regime and should not detract from the protection afforded to investors. Our proposed amendments to the Draft Regulation are set out in the "*Analysis*" section below.

ANALYSIS

<u>Category A issues</u>

(a) *The relationship between a KID and product terms and conditions*

A distinction that appears in the Commission's proposed regulation is that between the KID, on the one hand, and "marketing material" on the other (see for example Recital 14 of the Draft Regulation). We appreciate the distinction that the Commission draws. However, it is also important to consider that for many PRIPs, "marketing material" is not the only information currently provided to consumers and their advisers at the point of sale. In particular, the legal terms and conditions of the product are also routinely provided and, in the context

of securities PRIPs, will be included in the relevant Directive 2003/71/EC (**Prospectus Directive**) compliant prospectus, along with a number of other important regulated disclosures. These terms and conditions are important. They cannot be regarded as "marketing material" and national legal systems, including their alternative dispute resolution mechanisms (e.g. the Financial Ombudsman Service in the UK), do not treat them as such. The terms and conditions are legally binding and set out the rights and obligations of the parties.

It is not entirely clear from the Commission's proposal whether the Commission intends that a KID should replace or diminish the significance of the legal terms and conditions of the product. On the one hand, the Commission suggests that a retail investor "*should not be required to read other documents to be able to understand the key features of the investment product and take an informed investment decision"* (see paragraph 3.4.3 of the Commission's Explanatory Memorandum and Recital 10 to the Draft Regulation). On the other hand, the Commission clearly contemplates that firms and retail investors may enter into other agreements (see, for example, Article 11(3) of the Draft Regulation). To provide that a short form disclosure document like a KID should replace or be more significant than the legal terms and conditions of a product is contrary to the fundamental principles of contract law. The legal terms and conditions are vital for creating the product itself in law and for setting out the respective rights and obligations of the parties. We assume that it is not the intention of the Commission to undermine general contract law principles but the current drafting of the proposals do not make this sufficiently clear. Furthermore, we note that robust national and EU level regimes are already in place to regulate the nature of such terms and conditions (for example, the Unfair Consumer Contract Terms Directive 93/13/EEC).

We are also concerned by the legal implications of the idea that a retail investor "*should not be required to read other documents to be able to understand the key features of the investment product and take an informed investment decision*". Product terms and conditions are important to understanding the complete set of features and risks of an investment. The KID would be of most use to an investor as a summary of the key features and risks, not a replacement for the complete product terms and conditions. Instead the KID should prompt an investor to engage with the terms and conditions. We assume that the Commission's intention is that the KID should be designed to assist an investor in engaging with and understanding the legal terms and conditions of the products and the implications of these terms and conditions in terms of investment proposition, risk, reward and charges. As such, it is presumably the Commission's intention that consumers (or their advisers) would nonetheless be expected to read the other documentation provided to them when making their investment decision (and be bound by their terms), and to bear the risk if they elect not to do so. Where the product manufacturer or distributor has given an investor a proper opportunity to read terms and conditions drafted in clear and intelligible language[5], has provided clear, fair and not misleading product documentation, and the consumer then fails to read these materials, it is surely important that the investor, not the product provider or distributor, should bear the losses arising from that. Furthermore, it would appear inappropriate to us to legislate on the basis that a consumer should not be expected to consider "*other documents*" where those "*other documents*" include the actual terms and conditions of the product.

The role of the KID should be to assist investors in engaging with the legal terms and conditions of a product. It is not, however, in the interests of consumer comprehension or the functioning of the market, that the regime has the effect of absolving investors of the responsibility for fully engaging with the product literature or taking appropriate advice to assist them to do so. This is particularly the case given significant consumer protection provisions being incorporated into the MiFID and the Insurance Mediation Directive during the recent reviews of these regimes. These provisions include both product governance and investor identification requirements and specifically recognise that regulated entities may have responsibilities going beyond pure disclosure obligations where products are mis-sold.

(b) *The need for a coherent civil liability regime to support a KID*

The requirement to produce a KID, as proposed by the Commission, will not be workable unless it is supported by a coherent civil liability regime. A coherent civil liability regime should support, rather than detract from, the

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[5] Note that the Prospectus Directive (at Article 5(1)) already requires that disclosure of such terms is provided in an "easily analysable and comprehensible form".

desired focus on consumer friendly disclosure. Fundamental to this is ensuring that the requirements are structured in a way that product manufacturers and distributors can be satisfied that they are capable of objectively demonstrating compliance with their obligations under the Draft Regulation. Unless this prerequisite is met, many product manufacturers and distributors may feel unable to manage their disclosure risk in relation to PRIPs. This is likely to result in some product manufacturers and distributors exiting the market and reducing the range of products that are offered. This will result in a reduction in consumer choice and competition and an increase in the costs of products to consumers. It may also reduce the quality of products available.

We identify the following problems with the liability regime currently envisaged by the Draft Regulation:

(i) ***Basis of liability and coherence with other EU level disclosure regimes***. The civil liability relating to a failure to comply with the mandated disclosure requirements is set out in Article 11. However:

(A) it is inconsistent with that for UCITS KII documents and the Prospectus Directive summary.;

(B) in a securities context, it could make the recently updated Prospectus Directive regime irrelevant from a disclosure perspective, as standalone liability will attach to the KID. Given the recent detailed work on the updating of the Prospectus Directive, we assume that this is not the intention;

(C) it is not realistic, and hence misleading to investors, to suggest that a fully informed decision could be made on the basis of reading a KID alone. We assume that the Commission's intention is in fact that the KID would be one of the sources available to assist investors in taking an informed decision but would not be the only source of information that should inform them (as discussed, appropriate advice would also be essential to informing investor);

(D) it will discourage the inclusion of specific, high quality disclosure which may be of most use to investors. Requiring that retail investors "*should not be required to read other documents to be able to understand the key features of the investment product and take an informed investment decision*" will instead encourage generic, less meaningful disclosure aimed at technical satisfaction of the reversed burden of proof. A strict limit on the length of the KID would further compound this issue (see our specific comments in this regard in paragraph (e) of Section 2 below);

(E) it would severely compromise the ability of investment product manufacturers and distributors to manage disclosure risk. It will not be possible to prepare a short form disclosure document capable of allowing an investor to make a fully "informed investment decision"; and

(F) it fails properly to take into account that consumers must bear some responsibility for their investment decisions, in particular by reviewing the product documentation provided and by obtaining appropriate advice. We would argue strongly that it is wrong in principle to suggest that retail investors "*should not be required to read other documents to be able to understand the key features of the investment product and take an informed investment decision*". Retail investors or their advisers can and should reasonably be expected to read the documentation provided to them by a product manufacturer or distributor, including important documents such as product terms and conditions, or otherwise run the risk of not doing so.

<u>**JAC proposed amendment to the liability regime**</u>**: The civil liability regime should be amended to align it with that in place for UCITS and the Prospectus Directive summary i.e. "*that a person does not incur civil liability solely on the basis of the key investor information … unless it is misleading, inaccurate or inconsistent when read with the prospectus or, where no prospectus is prepared, the terms and conditions of the product.*". The reference to the terms and conditions as an alternative point of reference to the prospectus should address Commission concerns regarding the absence of a prospectus document for some PRIPs. The final sentence of the mandatory "explanatory**

statement" in Article 8(1) should also be amended to read "You are advised to read it to help to inform your investment decision."

These amendments are essential to:

(I) ensure coherence with the wider disclosure regime (e.g. in a securities context, to apportion appropriate emphasis between the PRIPs and Prospectus Directive regimes);

(II) ensure consistency of regulation between UCITS and other PRIPs (a fundamental aim of the PRIPs initiative); and

(III) ensure that product manufacturers and distributors are able to adequately manage their disclosure risk.

Critically, if a "stand alone" liability regime is coupled with subjective disclosure requirements and a reverse burden of proof as currently contemplated, the regime will give investors a free "put option" in relation to the product. Subject to an investor proving a loss, a product manufacturer would have to prove that the KID complied in all material respects with the requirements of the Regulation and failing that would have to compensate the investor (seemingly regardless of whether any identified fault in the KID actually caused the investor's loss). Given the subjective nature of the requirements, it would be very difficult for product manufacturers to be confident that they could prove that they had complied with their obligations. This risks a significant increase in speculative and vexatious claims and would have significant prudential consequences. Indeed, the uncertainty surrounding the potential liability for a product manufacturer may make issuance of such products unworkable.

(ii) ***Consistency with Member State civil liability regimes and reversal of the burden of proof***. The new liability regime which the Commission proposes in Article 11 would create much uncertainty. We submit that these proposals should be abandoned or substantially recast on the basis that: (i) it is unnecessary to legislate for civil liability at EU level in light of existing national laws; (ii) the Commission's proposals will be inconsistent and conflict with existing national laws; (iii) the Commission's proposals in Article 11 are not sufficiently well defined and so will create significant legal uncertainty and unnecessary litigation; (iv) the Commission's proposal to reverse the burden of proof is unnecessary in any event; and (v) as a matter of policy, the civil liability regime proposed by the Commission is too wide and would unfairly extend an investment product manufacturer's potential liability. We examine each of these propositions below.

Unnecessary in light of existing national laws

Existing civil liability rules in the Member States contain important safeguards to ensure fairness both to claimant retail investors and defendant financial services firms. These are tried and tested rules which have been refined over many years. We are not aware of any policy argument put forward by the Commission that the functioning of these regimes is in any way deficient. Given the complexity of negotiating and agreeing full civil liabilty safeguards into the Draft Regulation, we see no reason why the Draft Regulation should not cross refer to and rely upon existing civil liability regimes in the Member States.

In England, a retail investor provided with a non-compliant KID may have a right to claim damages on a number of legal bases (or 'heads' of liability). A claim for negligence would be subject to rules of English law governing the existence of a duty of care, breach, causation, remoteness and mitigation and the quantum of damages. A retail investor may also have a right to claim a different remedy for misrepresentation, essentially allowing the investor to "unwind" the contract, putting the parties back in the position they were before the investment was made, or potentially damages as an alternative to that. These types of remedy are already well understood, well defined, and as a matter of policy give retail investors ample protection.

In France a retail investor can efficiently bring a claim for breach of pre-contractual information obligations against a financial services firm, either under general tort rules or contract law. For example, a retail investor may have a right to claim damages on the basis of negligence. This right may arise either as a contractual claim and/or a claim in tort depending on the circumstances. French law would also govern issues of duty of care, breach, causation, remoteness and the quantum of damages though there is no duty to mitigate under French law. A retail investor may also have a claim based on mistake or misrepresentation or any other ordinary cause of nullity of contracts. Misrepresentation ("*dol*") occurs where a party voluntarily misleads its counterparty to enter into the contract either by positive acts, which include false statements, or by omission. Under French law, misrepresentation would allow the investor to "unwind" the contract, putting the parties back in the position they were before the investment was made (the investor can also request damages instead of, or in addition to, a request to have the contract annulled).

Our primary submission is, therefore, that in accordance with the principal of subsidiarity and following the approach taken for UCITS (Article 79(2) of the UCITS Directive) and the Prospectus Directive (Article 6(2)), the PRIPs regime should require Member States to ensure that their civil liability regimes apply and will provide for adequate remedies for breaches of the requirements of Article 8 of the Regulation. In doing so, the Regulation could state certain minimum requirements that must be satisfied by the relevant national regimes, to ensure a consistent minimum standard of protection is afforded to investors in all jurisdictions. Provided that they comply with this minimum standard, national regimes should be sufficient to meet the Commission's policy objectives. Other than establishing this broad framework, the PRIPs regime should not seek to set out detailed provisions as to the remedies appropriate during litigation under the laws of any Member State (for example, in relation to rescission or damages), as such remedies are already well established and efficiently achieved under national law.

Interrelationship with national laws

It is not clear from the Draft Regulation whether the civil liability regime that the Commission proposes in Article 11(1) would apply in place of, or in addition to, existing national law regimes (such as those described above), or how such regimes would interrelate. This creates legal uncertainty and may result in unnecessary litigation. This is a further reason for our primary submission mentioned in the preceding paragraph.

The liability regime in Article 11 is not sufficiently well defined

In the event that, contrary to our primary submission, it is considered necessary to legislate for civil liability at EU level, we submit that the liability regime proposed by the Commission is not sufficiently well defined and Article 11 must be recast. Product providers' and distributors' liability should be much more narrowly drawn for a number of reasons.

First, the Draft Regulation would render an investment product manufacturer liable for damages for a non-compliant KID which a retail investor "*has relied on when making an investment decision*". We submit that, at the very least, this must be amended to make it a requirement that the retail investor must *reasonably* have relied on the KID when making the investment decision. An example as to how this may otherwise result in an unfair outcome is provided at Annex 2 below.

Secondly, as currently drafted, the Draft Regulation would render an investment product manufacturer liable for damages for "*any loss caused to that retail investor through the use of the* [KID]" (our emphasis). The word "*any*" is unfairly wide, and the word "*use*" is an imprecise term which could potentially be read as inconsistent with the concept of "*reasonable reliance*". This ambiguous wording in Articles 11.1 and 11.2, leaves it open to argument that an investor need only demonstrate that (i) he "used" the KID (or the information therein) in making an investment decision (this may simply involve a general assertion which it will in practice be very difficult to refute), and (ii) has suffered some form of loss. Where this is established, the investment product manufacturer would then have to prove that the KID was in fact compliant or will otherwise be liable to compensate the investor for that loss. This

questions the need to demonstrate causation (i.e. that an investor's loss flows from the particular deficiency in the KID). We assume that this was not the Commission's intention as causation is a fundamental principle in any legal claim for a loss. As such, if Article 11 is to be retained, at the very least, it should be made clearer that a product manufacturer will only be liable for losses that are the "direct and reasonably foreseeable result" (i.e. directly caused by) of the investment product manufacturer's non-compliance with Articles 6, 7 or 8 of the Draft Regulation.

The reversal of burden of proof proposed is inconsistent with national laws and is unnecessary

In any event, we submit that the proposal for a reversal of the burden of proof (currently set out in Article 11(2) of the Draft Regulation) should be removed.

Recital 17 of the Draft Regulation recalls the policy justification for this aspect of the Draft Regulation. It states:

> "*As retail investors in general do not have close insight as to the internal procedures of investment product manufacturers, a reversal of the burden of proof should be established. The product manufacturer would have to prove that the* [KID] *was drawn up in compliance with this regulation.*"

This assertion fails to take into account the fact that in many alternative dispute resolution procedures across the EU, an investigating judge or an Ombudsman would have legal powers to compel the firm to produce the internal procedures and documents in claims or complaints brought by retail investors.

Furthermore, further protection is provided in the context of litigation in some Member States, notably those from the common law, where investors have a right to disclosure of documents in a legal action brought before national courts. For example, in the United Kingdom and Ireland, an investor would be able to obtain from the national court copies of the product provider's and product distributor's internal documents and procedures. The retail investor's own expert advisers would then review these and provide evidence to the court. This means that the retail investor can subject the product provider's internal processes to scrutiny in considerable detail, in a public forum.

On this basis, we would argue that the Commission's policy rationale for this provision is flawed as it fails properly to take into account the different consumer protection laws and alternative dispute resolution mechanisms of the Member States.

The civil liability regime proposed is too wide and unfair as a matter of policy

Finally, we submit that the Commission's proposed civil liability regime is simply too wide. We draw attention by way of example to section 90 of the Financial Services and Markets Act 2000 (**FSMA**) in the UK, which imposes statutory liability for untrue or misleading statements in a prospectus, or the omission of any matter required to be included in the prospectus, but also creates a number of exemptions (see Schedule 10 of the FSMA). The Draft Regulation does not contain a similar set of exemptions. As a matter of policy legislators should consider defining and including appropriate exemptions from liability.

As discussed further in paragraph (b)(i) above, the proposed liability standard, coupled with the reverse burden of proof, would expose the product manufacturer to a disproportionate level of risk (in effect reversing the principle of "innocent until proven guilty") and lead to a significant increase in speculative claims against product manufacturers. It cannot be the Commission's aim to create such damaging legal uncertainty, particularly where the Commission's policy goals can be met by alternative means that are already employed to support other analogous regimes (e.g. the UCITS Directive and Prospectus Directive).

<u>JAC proposed amendment to the liability regime</u>: Our primary submission is that, in line with the approach taken for UCITS and under the Prospectus Directive, the provisions reversing the burden of proof should be removed and the Draft Regulation should instead contain a provision stating that the national laws of the Member States shall provide for adequate civil remedies for a retail investor which has reasonably relied on the KID when making an investment decision and suffered loss as a result of the KID's non-compliance with Article 8 of the Draft Regulation. In the event that it is nonetheless concluded that it is necessary to legislate for civil liability at EU level, Article 11 must be recast and drawn more narrowly to incorporate the concept of *reasonable* reliance, limiting liability to foreseeable loss only and clarifying the meaning of "*use*" of the KID. In any event, we submit that the proposal for a reversal of the burden of proof should be removed, and legislators should consider defining and including an appropriate set of exemptions from liability.

(iii) ***Control of disclosure document and liability for distributor breach***. The entity responsible for delivering the KID to investors (i.e. the distributor (see Article 12)) is likely often to be a different entity to that responsible for the preparation and content of the KID. The Draft Regulation could make the product manufacturer liable in the event of a failure by the entity selling the product to comply with the requirements of Article 12. Provisions to address this should be included to ensure that liability is appropriately apportioned where a distributor circulates a KID that is either inaccurate or out of date without the consent of the product manufacturer. Inclusion of such provisions are important for product manufacturers and should not prejudice the interests of investors.

<u>JAC proposed amendment to introduce control regime and clarify product manufacturer liability</u>:

A new paragraph 2 should be inserted in Article 12 stating:

"*In no event shall a person selling an investment product to retail investors provide such investors with a key information document without first obtaining the written permission of the investment product manufacturer to do so. Such permission may be given by the investment product manufacturer on an indefinite basis for a limited period of time or subject to other conditions. Where any specified condition is not met, such permission will no longer be valid for the purposes of this paragraph 2.*"

A new paragraph 3 should be inserted in Article 12 stating:

"*In the event a person selling an investment product to retail investors either:*"

(a) fails to provide investors with a key information document; or

(b) provides investors with a key information document in respect of which it has not obtained the permission required under paragraph 2 above,

***the sole responsibility for this breach will lie with the person selling such investment product and, unless the investment product manufacturer is the person making such sale, no liability shall arise for the investment product manufacturer.*"**

(iv) ***Liability for KIDs where the product has been altered***. The Commission's Explanatory Memorandum (published alongside the Draft Regulation) makes it clear that not all alterations to an investment product will result in the entity altering such product becoming the relevant "investment product manufacturer" for the purposes of responsibility for the KID. Such subsequent alterations may be outside of the control of the "investment product manufacturer" and the product manufacturer cannot be expected to take responsibility for inaccuracies in the KID which result from alterations made to the investment product by another entity.

<u>JAC proposed amendment to liability regime for altered products</u>: The liability regime set out in the Level 1 instrument must make it clear that the product manufacturer shall not be responsible for a KID failing to comply with the requirements of the Regulation as a result of alterations made to the investment product by another entity.

This could be achieved either:

(I) by insertion of a separate provision stating this fact; or

(II) by amendment of the definition of "*investment product manufacturer*" such that limb (ii) of that definition reads "*any natural or legal person who makes any change to an existing investment product (including alterations to its risk and reward profile or the costs associated with an investment in the investment product) that has the result of causing the key information document prepared in respect of that investment product to no longer comply with the requirements of this Regulation*".

(v) ***Precise content and style requirements***. As a Level 1 instrument, the Draft Regulation gives outline content requirements only (see Article 8) with the detail to be completed at Level 2. The content requirements provided for at Level 2 will need to:

(A) be expressed in objective terms to allow product manufacturers to be able to satisfy themselves (from a risk management perspective) that they have satisfied their obligations and would be able to objectively demonstrate this if challenged by an investor; and

(B) be limited to information that is within the knowledge and control of a product manufacturer. This reflects the fact that the product manufacturer will be required to take responsibility for the KID (and will hence be liable for inaccuracies). In particular, any distributor-specific information should not be required to be included in the KID.

JAC proposal: The Draft Regulation should confirm that Level 2 work must create objective content requirements for the KID which are limited to information known by and within the control of the product manufacturer.

Our more detailed observations in this regard are included in the "*Key Issues (Level 2)*" section below.

(vi) ***Length***. The Impact Assessment indicates a preference for a consideration of a "soft" page limit to be discussed at Level 2. We support this proposal and note our detailed observations in relation to the length of the document in the "*Key Issues (Level 2)*" section below. If the question of length is to be covered at Level 1, the issues highlighted below will need to be considered carefully.

JAC proposal: The mandated length for the KID must be sufficient for all of the disclosure requirements to be adequately addressed. Otherwise this will render the document unworkable.

(vii) ***Review/revision requirements***. We note the provisions of Article 10 that the detailed requirements relating to review of the information in the key information document will be determined at Level 2. Please see our detailed observations in this regard in paragraph (d) of Section 2 below. Given that the KID provides information to assist an investor when making an investment decision, it seems logical that the requirement to update the KID should only apply during periods when such a decision may be made (i.e. during the offer period for the investment product) and not throughout a product's lifetime. A requirement to review and revise any key information document on a constant or very frequent basis will result in unnecessary and unsustainable administrative cost with no benefit for consumers.

JAC proposal: A KID should only be required to be up to date at the point when an offer or sale is made.

Please see our detailed observations in the "*Key Issues (Level 2)*" section below.

(vii) ***Alternative dispute resolution (ADR) procedures***. Article 15 of the Draft Regulation sets out a requirement that a product provider or product distributor must participate in ADR procedures that meet certain criteria. However, the criteria specified in Article 15 of the Draft Regulation appear arbitrary and the effect of them may be to disapply certain existing ADR procedures which are already well established in national law, and which (in the absence of Article 15) would otherwise be able to adjudicate on disputes about rights and obligations relating to a KID.

In particular, the Financial Ombudsman Service (**FOS**) in the UK would not qualify under Article 15, because (i) (contrary to Article 15(a)) an Ombudsman's decision is binding on both the firm and the complainant at the option of the complainant; (ii) (contrary to Articles 15(b) and (c)) in the UK there is no suspension of court limitation or "prescription" periods where a retail investor complains to the FOS instead of filing a claim in court - it is rightly for the investor to choose where he wishes to start his complaint, taking into account any applicable time limits; and (iii) (contrary to Article 15 (f)) the FOS' decision making procedures do not provide for formal interim measures. Similarly, the alternative dispute resolution procedures introduced by various banking associations in Germany would also not qualify under Article 15 since their decision making procedures do not provide for formal interim measures (contrary to Art 15 (f)).

Moreover, the Draft Regulation is silent about the position where an ADR mechanism already exists in national law but does *not* fulfil the requirements set out in Article 15. This creates unwelcome uncertainty. Must a product provider participate in that national law ADR mechanism anyway if required to do so by national law, or would a product provider be entitled to rely on the Draft Regulation to 'override' national law, arguing that disputes concerning rights and obligations under the Draft Regulation can as a matter of directly effective EU law *only* be dealt with under procedures that conform to the Article 15 criteria? It would appear from the Commission's use of the conditional word "*provided*" in Article 15(1) that the latter is in fact the correct position. The drafting here is insufficient; there is a policy decision to be taken, and Article 15 must be recast to avoid unnecessary litigation.

Under Article 15 as currently drafted, it would seem that certain well established Member State ADR mechanisms would not have jurisdiction to consider a complaint by a retail investor that a KID was improperly drawn up, but would have jurisdiction to consider other aspects of the same complaint that for all practical purposes might be indistinguishable (for example a general complaint such as "the information I received from my financial adviser was inadequate").

Moreover, it is wrong in principle that a Member State which already has a well established ADR mechanism for financial services complaints should be required to set up a further mechanism to adjudicate specifically on complaints about rights and obligations established under the Draft Regulation. That mechanism would have to be funded either by the taxpayer, by retail investors, by industry, or by a combination of these. If this is what the Commission intends, we submit that it would be unnecessary, bureaucratic, wasteful and duplicative of existing national law mechanisms.

We submit that Article 15 should either be deleted or recast to make it clear that disputes relating to rights and obligations under the Draft Regulation can be adjudicated via existing ADR procedures set up under national law, which already have wide jurisdiction to consider complaints about financial services provider firms. The Commission will be familiar with such organisations as they are typically already members of FIN-NET.

Similarly, Article 15 must be recast to recognise that the provision of any information between entities responsible for such ADR procedures or competent authorities (as currently contemplated by Article 16 of the Draft Regulation) must be subject to national law measures which protect confidentiality and restrict the transfer and processing of sensitive personal data.

JAC proposal: Article 15 should be either deleted or recast it to make it clear that disputes about retail investors' and firms' rights and obligations under the Draft Regulation may be dealt with in

existing national ADR procedures established under national law that have jurisdiction to consider complaints about financial services firms.

Category B issues

(viii) ***Interaction with the Prospectus Directive issue specific summary***

As part of the Prospectus Directive review, the retail summary requirement under Article 5(2) of the Prospectus Directive (as amended) has been revised to require the preparation of an issue specific retail focussed summary document (the **PD Issue Specific Summary**). This PD Issue Specific Summary is in addition to the summary in the base prospectus which will still be required. Whilst taking a different form to the KID envisaged by the Draft Regulation, the PD Issue Specific Summary is designed to perform a very similar function to the KID (i.e. provide summary disclosure tailored to retail investors).

In acknowledgement of this, Recital 27 to Directive 2010/73/EU (the amending Directive to the Prospectus Directive) stipulates that, once the PRIPs initiative is concluded, the Commission should use delegated acts to ensure that the content and form of the Prospectus Directive summary is aligned "*to the greatest extent possible*" with the provisions for summary disclosure under PRIPs "*preventing the duplication of documents and potential confusion for investors as well as minimising costs*". The current wording of the Draft Regulation conflicts with this requirement.

The requirement to provide both a PRIPS KID and PD Issue Specific Summary in the context of an offer of securities to retail investors also fundamentally conflicts with the expressed intention of the PRIPs initiative in that:

(A) it is confusing for investors to receive two summary documents and adds to the perception of information overload;

(B) it is contrary to the aim of regulatory harmonisation, creating an unlevel playing field as between securities PRIPs that are subject to the PD and other PRIPs; and

(C) having two distinct but duplicative short form disclosure requirements will add significantly to product costs (impacting the return received by investors)without any discernible investor benefit.

To ensure that this important matter is addressed, amendment to the PD Issue Specific Summary regime should be specifically provided for in the Level 1 instrument for PRIPs.

JAC proposed amendment to remove the requirement to produce a PD Issue Specific Summary where a KID is produced – Article 3 of the Draft Regulation should be amended to include provisions amending the Prospectus Directive to clarify that once the KID regime is introduced, either (i) the PD Issue Specific Summary regime will cease to apply or, alternatively (ii) where a KID is required to be produced for any product, a PD Issue Specific Summary will not be required.

As above, we note that any such amendment would not affect the base prospectus summary regime, which is separate from the PD Issue Specific Summary.

Such amendments would ensure that the highest standard of disclosure is maintained whilst ensuring the aim of a level playing field is not compromised.

Category C issues

(ix) ***Clarification of Article 5 of the Draft Regulation***

Article 5 of the Draft Regulation states:

"*The investment product manufacturer shall draw up a key information document … for each investment product it produces and shall publish the document on a website of its choice before the investment product can be sold to retail investors*"

Whilst the Commission's Explanatory Memorandum makes it clear that a key information document would only need to be prepared where investment products are actually sold to retail investors, the wording of Article 5 above is ambiguous. It is unclear on its face whether (a) the key information document must be produced for all products but it is the website publication that is the prerequisite for retail sales or (b) both the production and website publication are contingent on retail sales.

JAC proposed amendment to remove ambiguity in Article 5 - Article 5 of the Draft Regulation should be amended to read:

"*Before an investment product can be sold to retail investors, the investment product manufacturer shall draw up a key information document in accordance with the requirements laid down in this Regulation for that investment product and shall publish the key information document on a website of its choice.*"

(x) ***Scope of the term "retail investors"***

We assume that the Commission's intention is that a "*customer*" under Directive 2002/92/EC (the Insurance Mediation Directive or **IMD**) would only be a "retail investor" for the purpose of the Draft Regulation in respect of "investment products" that would themselves be subject to regulation under the IMD.

JAC proposed amendment to clarify Article 4(c) - Article 4(c) of the Draft Regulation should be amended to read:

"*(c) 'retail investor' means:*

(i) for the purpose of any investment product which is subject to regulation under Directive 2002/92/EC, any person that would be a "customer" for the purposes of Directive 2002/92/EC; and

(ii) for the purposes of any other investment product, any "retail client" as defined in point (12) of Article 4(1) of Directive 2004/39/EC."

(xi) ***Territorial scope***

It will be important to clarify the territorial scope of the Draft Regulation. We assume that that intention of the Commission is that the territorial scope is to be limited to investment products sold to retail investors located in EEA Member States but that it would apply to all product manufacturers and distributors regardless of where they are located (i.e. extra-territorial application to product manufacturers and distributors outside the EEA if the relevant products are sold to retail investors located in the EEA). This should be clarified in the text of the Draft Regulation.

We assume that the Commission does not intend either:

(A) the territorial scope of the Regulation to be limited to investment product manufacturers and distributors located in EEA Member States where investment products are sold to retail investors (wherever such retail investors are located (including outside the EEA)); or

(B) the Regulation to apply only to investment product manufacturers and distributors located in EEA Member States to the extent the investment products are sold to retail investors located in the EEA.

SECTION 2. KEY ISSUES (Level 2)

SPEED READ

The following points will need to be addressed at Level 2:

- Precise content and style requirements, including:
  - objective parameters to allow investment product manufacturer's to be confident that they have satisfied their obligations.
  - clear scope of what is, and is not, considered "key information", including clarification as to whether product obligor disclosure is required and if so, to what extent.
  - clarification of certain other key terms and concepts, including "amount repayable", "manufacture", "embed a derivative" and alteration of an investment product.
- If the investment product manufacturer is to be liable for the KID, content requirements must be limited to information within the knowledge and control of the investment product manufacturer.
- Development of a glossary would be beneficial to both investors and the industry.
- Review and revision requirements must reflect the pre-contractual nature of the KID. Information which is potentially subject to constant change should be subject to periodic rather than continuous review.
- Length requirements should consider the space that will be required to provide high quality summary disclosure. Too short a document will result in over simplified disclosure which will reduce the utility of the document to investors. Requirements to be clear and concise are preferable to arbitrary length restrictions.
- A synthetic risk reward indicator should not be included on the basis it is likely to mislead investors and discourages investor engagement with the full risk profile of the product.
- Methods for presenting charges and past performance information that have been employed for UCITS KII are not appropriate for other PRIPs products with different charging and structuring profiles.

As a general comment, there are a number of points in the Level 1 text that will require further elaboration. The text should provide for Level 2 measures accordingly, rather than leaving important elements of the KID framework to Level 3 guidelines or leaving individual Competent Authorities to form their own interpretation of the Regulation. Where possible, Level 2 measures should take the form of Technical Standards to ensure swift adoption of a complete legislative framework.

ANALYSIS

(a) ***Precise content and style requirements***. As noted under Section 1 above, it is essential that the obligations of a product manufacturer are clear and that compliance with such obligations is capable of objective proof. This will be particularly important if standalone liability and a reverse burden of proof is maintained. Further clarification of a number of key terms and concepts will need to be provided at Level 2, including:

(i) objective parameters governing the requirement for disclosure to be presented in a "clear, succinct and comprehensible" form;

(ii) detailed examples of what information would and would not be considered "*key information*". In particular, the Draft Regulation makes no reference to whether product obligor disclosure will be required to be included in the KID (e.g. information relating to the identity and risk profile of the issuer and/or guarantor of securities PRIPs). Obligor disclosure is not contemplated for

UCITS KII because a UCITS is a fund and hence obligor credit risk is not relevant. We would suggest that either (i) it is made clear that the KID should focus on key information relating to the structuring (i.e. "packaging") of the relevant PRIP only and that consequently obligor disclosure is not required in the KID or (ii) that the obligor disclosure required in the KID is specifically limited to the name and a website of the obligor(s) only and a cross reference to any relevant disclosure document. For Prospectus Directive securities, this is on the basis that both detailed and summary form investor friendly obligor disclosure is already required to be provided in the regulated base prospectus. The KID would be required to cross reference the obligor disclosure in the prospectus. If more detailed product obligor disclosure is to be required in the KID, any length restriction placed on PRIPs for which obligor disclosure is relevant will need to reflect the additional space that will be required to provide such disclosure;

(iii) the meaning of "*amount repayable*" in the definition of "*investment product*". Specifically, would this include (i) the principal amount and/or any other amounts payable at maturity, (ii) interest payments; and (iii) any early redemption amounts;

(iv) what does the term "*manufacture*" mean for the purposes of the definition of "*investment product manufacturer*", and what is the threshold for an alteration to an existing product triggering limb (ii) of that definition. Section 3.4.2 of the Commission's Explanatory Memorandum suggests only changes that "substantially" or "significantly" alter the structure of the existing "investment product" would trigger this requirement though it will be important for the Level 2 instrument to confirm specific examples of activities that would and would not result in an entity altering an existing product becoming a distinct "*investment product manufacturer*". More specifically:

(A) in what circumstances might a distributor charging fees result in that distributor being classified as a distinct "*investment product manufacturer*";

(B) what is the status of a plan manager distributing investments under a UK investment plan and what is the "*investment product*" in these circumstances: the investment plan or the underlying product? Does this hold true if the investment plan only invests in a single underlying product? Would the same analysis apply where any third party is "wrapping" an investment product (e.g. unit linked life insurance schemes)?;

(C) what is the status of a distributor offering the product in the secondary market under different offer terms (e.g. issue price or offering period) to those originally envisaged by the issuer of the product?

(v) What the term "*embed a derivative*" means, and more specifically what does "*embed*" and what does "*derivative*" mean for these purposes? Will all products that "*embed a derivative*" necessarily be "*investment products*"?

As a further point, the ESMA guidance relating to style and content provided in respect of the UCITS KID was deficient in a number of ways. Industry feedback in consultations on these points was not taken into account. In particular, the ESMA guidance contained provisions that were imprecise and in practice impossible to implement and the industry is keen to avoid similar issues in the context of PRIPS. In this regard, rigorous oversight of the Level 2 work and any Level 3 guidance will be required.

(b) ***Scope of Level 2 content requirements***

Article 5 provides that the product manufacturer will be required to take responsibility for the KID (and will hence be liable for any inaccuracies). As such, as noted in section 1 above, any content requirements formulated at Level 2 must be limited to only such information that is within the knowledge and control of a product manufacturer. In particular:

(i) any distributor-specific information should not be required to be included in the KID; and

(ii) any costs or risk information which requires tailoring to, or is contingent upon, the identity or nature of specific investors should not be required to be included in the KID.

It is not workable from a risk management perspective to require a product manufacturer to take responsibility for information which is not within its knowledge or control.

(c) ***Development of a glossary of common terms***

We support the Commission's suggestion that a glossary of common terms be compiled. Compiling a glossary for the diverse products that fall within the PRIPs scope will be a demanding task. However, it will deliver considerable benefits both for consumers and the industry by facilitating consistency, comparability and standardisation of disclosure. It would also assist with the Commission's separate investor education policy goals. The JAC has already undertaken detailed work in this area for the purposes of previous submissions to the Commission and to CESR. The JAC would welcome the opportunity to provide further input into this Level 2 workstream which would need to be fully developed prior to implementation of the regime.

(d) ***Review and revision requirements***. As noted in Section 1, Article 10 provides that the detail of the regime addressing review and revision of the key information document will be addressed at Level 2. Given that the purpose of the KID is to help inform investment decisions, the principle for this Level 2 work should be that the KID should only be required to be up to date at the point when an offer or sale is made.

As the Commission appears to acknowledge, this will mean different regimes should apply depending whether an investment product is offered continuously or non-continuously (see Article 10(2)(c)). Whilst a focus should be retained on the quality of disclosure, it is essential to ensure that any requirements relating to review and revision are proportionate and do not impose an unjustifiable administrative burden on product manufacturers.

We would suggest that the following general principles would assist in achieving this goal:

(i) the update of information in the KID should be limited to material changes only (similar to the supplementary prospectus regime under Article 16 of the Prospectus Directive);

(ii) any requirement to include "dynamic information" (i.e. information which may be subject to subsequent change and hence updating) in the KID, should be carefully vetted to ensure that it is kept to the minimum necessary to ensure high quality disclosure for investors.; and

(iii) information that may be subject to constant change (e.g. past performance information and any risk indicator calculated by reference to performance) should be subject to distinct review and revision requirements which provide for update on a periodic basis (e.g. annually).

For non-continuously offered products, the key information document should only be required to be up to date for the duration of the offer period for the relevant product. Key information documents for continuously offered products would be required to be up to date (subject to parameters (i) to (iii) above) during all periods in which one or more distributors had the permission of the relevant product manufacturer to use the key information document (see "*Control of disclosure document and liability for distributor breach*" in section 1 above). During periods in which no such permission was outstanding, the obligation to review and revise the key information document would lapse.

(e) ***Length***. The Impact Assessment indicates a preference for a consideration of "soft" page limits to be discussed at Level 2. As noted in Section 1 above, it is essential to ensure that where page limits are imposed, these reflect the space required to meet the mandated disclosure requirements. For example,

the two page limit specified for non-structured UCITS, would not be sufficient to give high quality, investor friendly summary disclosure in the context of most PRIPs.

We note further that the assumption that a shorter document is necessarily a more comprehensible document for a retail investor is not correct. This is reflected in the UK FSA enforcement action in respect of summary disclosure discussed above and the flexibility in length permitted under the Hong Kong KFS short form disclosure regime, where the page limit may be relaxed to permit the use of presentation techniques which make information more accessible for investors (for example, graphs, charts and tables). Furthermore, experience of drafting the UCITS KID demonstrates that expressing complex concepts in plain terms often requires the use of more words, but the ultimate outcome is disclosure that is easier for a retail investor to engage with and understand. Guidance as to length (provided that it reflects the mandated disclosure requirements) is helpful, particularly where that is supplemented by an overriding requirement that disclosure must be succinct. An arbitrary and fixed page limit risks unnecessarily limiting a product manufacturer's ability to provide appropriately tailored disclosure.

(f) Synthetic Risk Reward Indicator

The JAC has strong reservations regarding the inclusion of a risk indicator. Such an indicator risks misleading investors and runs contrary to the aims of improving investor comprehension of the risks involved in the relevant product. A summary of the arguments raised by the JAC in previous submissions is included at Annex 3 below.

(g) Charges/Past performance/Scenario analysis/

The JAC has discussed the content and presentation of charges, past performance and scenario analysis information in its previous submissions to the Commission. Please see items 2.5 and 2.9 of Section A of the JAC's submission of 30 June 2010 available at:

http://www.isda.org/uploadfiles/_docs/JACSubmissionretemplateKID100710.pdf

and the further discussion at Annex 4 below. These raise important points for consideration in structuring the regime to apply for the PRIPs KID.

ANNEX 1

EXAMPLE OF UK FSA ENFORCEMENT ACTION

The FSA recently found that a financial services firm had breached UK financial services rules when it gave financial advice to its customers by describing a product using summary language like "*cash*", and "*an alternative to traditional bank and building society deposits*". The product being described was a unit-linked life assurance investment bond (a form of PRIP sold in the UK) which offered a choice of funds for investment at differing levels of risk. The FSA, which imposed a financial penalty on the firm, emphasised that these descriptions of the PRIP were inaccurate, insufficiently detailed, and liable to mislead those investing in it. This highlights how an attempt to summarise or simplify a product description may have unintended negative consequences. Put simply, the FSA found that the product was complex, and it was important that investors were aware of the details.

Moreover, it is important to recognise that whilst investors should be (and usually are) concerned principally with the economic nature and risks of their proposed investment, some investors are attracted to certain types of PRIP precisely *because* they have a particular legal form or other technical feature. Some such products compete with one another precisely because of their technical features. For example, a key reason for some investors choosing a PRIP over another product is because under the laws of individual Member States, the PRIP may receive a more favourable tax treatment. The tax treatment depends on the legal form of the instrument the investor is acquiring. It is vital that the Commission's efforts to improve consumers' ability to compare products does not prevent them, or their financial advisers, from properly understanding more technical features of the products in which they are investing, or prevent the products themselves from competing with one another on technical characteristics.

ANNEX 2

In relation to our observations under the heading "The liability regime in Article 11 is not sufficiently well defined" we believe that the following example is illustrative of the issue discussed:

A situation may arise where a product manufacturer creates a PRIP to meet the needs of a defined group of investors (X), and only those investors. The product manufacturer provides a KID which states clearly whom the product is intended for in the section of the KID entitled "*what is it for?*". However, unknown to the product manufacturer, a member of group X passes the KID to a different investor Y who has different demands and needs, whom the product manufacturer did not intend should buy the product. Y "*relies*" on information in the KID to make his investment decision. He "*uses*" the KID, by reading most of it, but he ignores the sections entitled "*what is it for?*" and "*what are the risks and what might I get back?*" Y then suffers loss and makes a claim against the product provider, alleging that it failed to draw up the KID in accordance with Article 8 of the Draft Regulation. Y alleges that the product provider failed to mention a particular risk in the section entitled "*what are the risks and what might I get back?"* that was material to him but would not have been material to any investor in group X. The product provider argues that because no member of group X would have considered that risk to be material, there was no reason to include it in the KID.

Under Article 11 of the Draft Regulation, there is a prospect that Y would be able to show that (i) he relied on information in the KID to make his investment decision (though only some of it, not all of it); and (ii) he suffered loss through "use" of the KID (though it is arguable whether use of the KID actually caused his loss). It is likely that the investment product manufacturer would have to satisfy the national court, at considerable expense in litigation, that it drew up the KID in accordance with Article 8 of the Draft Regulation. The product provider would be required to incur the expense of obtaining expert evidence to prove that it behaved reasonably when it wrote the section entitled "*what are the risks and what might I get back?*" because it only had group X in mind.

We submit that the product manufacturer plainly should not be liable to compensate Y in these circumstances - *not* because it could show that the KID was properly drawn up with group X in mind – but simply because Y's "*reliance*" on the KID and his "*use*" of it were not reasonable in the circumstances. A reasonable retail investor would not rely on a KID without reading all of it, and had he done so, he would have realised that the PRIP was not the right product for him.

ANNEX 3

SUMMARY OF ARGUMENTS RAISED IN PREVIOUS JAC SUBMISSIONS RELATING TO RISK DISCLOSURE

Risk disclosure

In line with the desire to focus on key product specific information only, we would propose that the risk disclosure to be included in the KID contains only disclosure relating to the "key risks" of the product. Risks that would relate to all products of the relevant product category (for example, in the case of securities, risks that apply to securities generally) would not be included. Instead cross references would be incorporated referring investors to the disclosure relating to those more general risks set out in the relevant offering document. We would argue that specific cross-references of this nature will enhance, rather than detract from, the utility and effectiveness of the KID as a disclosure instrument. Such cross references allow the KID to focus investor attention on the specific risks involved with the particular investment proposition under consideration.

We believe that risks should be disclosed in a narrative format rather than in the form of a risk indicator. We feel that this approach would offer optimum disclosure for investors and is most likely to improve genuine comprehension of the risk involved. We would support an approach of framing the disclosure as answers to questions to which an investor could easily relate.

The JAC believes that the incorporation of a Synthetic Risk Reward Indicator (**SRRI**), as suggested by the Commission, is likely to be detrimental to investor understanding, on the basis that:

(i) the Commission's own consumer research suggests that investors tend to place undue emphasis on a risk indicator. The research further suggests that investors do not pay sufficient attention to warnings noting the limitations and assumptions that apply to the indicator. This necessarily distorts an investor's conclusions as to the risks inherent in the product and the significance they should place on the indicator. This is a particular concern in the context of non-UCITS PRIPs for which the risk profile is generally more diverse than that involved in a UCITS (in particular, given the additional obligor credit risk dimension). A single figure rating discourages investors from fully engaging with the detail of this risk profile. This must surely detract from the value of the KID as an investor education document;

(ii) PRIPs have diverse risk profiles and risk is often investor specific. For example, an investor investing in a product denominated in a currency other than that of his home member state takes significant foreign exchange risk which may not be factored into the indicator. Consequently, narrative risk explanations are far more useful to investors, allowing them to assess the relevance of each risk factor identified in the context of their specific portfolio;

(iii) Whilst an attractive notion, finding a common SRRI calculation methodology that could be used across the full range of PRIPs would represent a significant, if not impossible, challenge. The nature of structured securities (and indeed a number of the other contractual PRIPs products) is fundamentally different to UCITS. For example, no "strategy" applies and collateral arrangements (if indeed these apply at all) are arranged on a different basis. As such, the regime applying to UCITS would not easily be transposed to other PRIPs products in a way that would allow for reliable or meaningful ratings to be produced. We note that there is already evidence suggesting that the methodology developed for UCITS is not working as intended.

    Were different methodologies to be applied to different product categories, there is a significant risk that investors would nonetheless regard the index scores as comparable across product categories. This could offer an unfair advantage for certain products for which the categorisation framework was more favourable.

(iv) computing a calculation basis for a risk indicator for products for which there is no (or limited) past performance data presents significant challenges. Furthermore, any element of subjectivity introduced into the calculation methodologies for such products (as may be unavoidable), would open the party calculating the rating to liability risk in respect of investors subsequently seeking to challenge an assumption made in the course of such calculation;

(v) where a risk indicator is used, significant space would be required to set out the explanation of the indicator, the score and the warnings in relation to its reliability. This would reduce the space available for more meaningful disclosure of the actual risks involved in the product and add unnecessary clutter to the document in which space is already at a premium; and

(vi) there are concerns that, in the context of capital protected products which are highly complex but relatively low risk (e.g. complex structuring might be used to reduce risk), an inappropriately designed indicator may incorrectly score these products as higher risk due to their complexity.

We note further that it is reported that the numeric indicator was considered but then rejected by the Monetary Authority of Singapore in relation to their proposed Product Highlights Sheet.

The JAC has provided more detailed analysis of the limitations of the calculation methodologies considered by CESR in relation to the UCITS KID in its response to CESR's Consultation Paper (09-552). This analysis is available at www.isda.org/c_and_a/pdf/KID-disclosures-for-UCITS-JACresponse.pdf.

ANNEX 4

CHARGES DISCLOSURE

Extract of paragraphs 33-37 of the JAC November 2009 submission to the Commission:

"Collective Investment PRIPs [*as defined below*] must be subject to a fee disclosure regime. This is because the fees concerned are deducted from the performance of the underlying assets, and are therefore charged directly to the customer. For products of this kind, a customer cannot calculate his expected return on his investment unless he knows the level of such costs.

This is not generally true of Contractual PRIPs [*as defined below*]. A Contractual PRIP is a product which specifies to the investor exactly what he will receive at a future time. For such products there are no "costs" in the sense given above. For example, a deposit account customer has no need to know what happens to his money once it is deposited – his entitlement to the return specified when he made the deposit is not affected by the question of what the bank concerned did with his money once it received it and whether such bank made or lost money with the proceeds of the deposit. The same is true for structured bonds.

Contractual PRIPs and Collective Investment PRIPs are priced differently. A Collective Investment PRIP is a packaged offer of a service for a fee, and the fees charged for the provision of that service are generally absolute and not performance related. Thus what the investor will get as his investment return will be the investment performance less the management fee charged. He therefore needs to know the management fees charged in order to be able to work out what his investment return is likely to be. A Contractual PRIP, by contrast, will pay the defined return – fees and costs are already taken into account in the calculation of the return which is defined. The issue for the investor is as to whether the price which he is being charged for that return is cheap or dear, and he – or, usually, his investment adviser or broker – can establish this by looking across the range of competing products and structures. A useful comparison can be made with bank deposits – an investor is not told, and does not need to know, the return which the bank hopes to make over its funding costs on the particular deposit.

What follows from this is that it is incorrect to regard a Contractual PRIP as a species of managed fund. The investor pays a price to receive a structured return, and the return which he receives will be the return specified in the documentation. The profit or loss which may be made by the producer of the product is not analogous to the fees charged by the manager, since management fees are deducted from the return which the investor would otherwise have received, whereas product profits made or losses suffered are not. Consequently, disclosure of profit margins or losses on hedging is irrelevant to Contractual PRIPs.

This is a manifestation of the fact that it makes little sense to speak of comparing profitability even between different PRIPs. The fact that one institution has a different trading strategy from another, with a higher toleration of risk and therefore a higher prospect of return, is irrelevant to an investor choosing between the products of the two institutions. The key point is that the investor is unaffected by losses made on the hedge, in the same way and for the same reason that he does not participate in the gains. It is therefore seriously misleading to compare the profit made on hedging retail products with the management fee derived by a fund manager from his management activities. One is disclosed to the customer because it comes out of his pocket. The other is not because it does not."

As a further point, if, in spite of the arguments above, it is felt that more detailed charging disclosure is desirable for Contractual PRIPs, it would seem to us that to ensure coherence of the regulatory regime, the most appropriate place to address these issues would be as part of the MiFID II/ MiFIR workstream rather than under the PRIPs KID legislation. As noted above, regulatory coherence is one of the core aims of the PRIPs initiative.

For the purpose of the above, the term **Contractual PRIPs** refers to products that entitle their owner to an amount of money calculated by reference to a formula. Contractual PRIPs include deposits, structured bonds, warrants and certificates, annuities and some life insurance policies. Contractual PRIPs are defined return

investments. The term **Collective Investment PRIPs** refers to products that entitle their owner to the return on a pool of assets in which his initial contribution has been invested, less fees. Collective Investment PRIPs include UCITS, shares in investment companies and some life insurance policies. Collective Investment PRIPs are variable return investments.

ANNEX 5

ABOUT THE ASSOCIATIONS

About the Joint Associations Committee

The JAC is sponsored by multiple associations with an interest in structured products, including the International Swaps and Derivatives Association (ISDA), the International Capital Market Association (ICMA), the Association for Financial Markets in Europe (AFME), the British Bankers' Association, the Asia Securities Industry & Financial Markets Association (ASIFMA), SIFMA, the Associazione Italiana Intermediari Mobiliari (ASSOSIM), the Institute of International Finance, Inc. (IIF) and the UK Structured Products Association (UK SPA). The members of the JAC comprise most of the major firms (both financial institutions and law firms) involved in the creation and, to some extent, distribution of structured securities which are distributed to retail investors.

About the British Bankers' Association

The British Bankers' Association (BBA) is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

BBA is listed on the EU Register of Interest Representatives, registration number 5897733662-75

About ICMA

ICMA represents financial institutions active in the international capital markets; its members are located in 50 countries, including all the world's main financial centres. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years, providing the framework of rules governing market practice which facilitate the orderly functioning of the market. ICMA actively promotes the efficiency and cost effectiveness of the capital markets by bringing together market participants and regulatory authorities. For more information see: www.icmagroup.org.

ICMA is listed on the EU Register of Interest Representatives, registration number 0223480577-59

About ISDA

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 825 member institutions from 57 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

ISDA is listed on the EU Register of Interest Representatives, registration number: 46643241096-93

About UK SPA

The UK Structured Products Association (UK SPA) is an organisation established by the UK's leading companies that create and distribute structured products to the UK financial services market in order to provide a useful and responsive source of information, education and comment on structured products by promoting their contribution to effective financial planning.

The UK Structured Products Association is committed to publishing research, information and educational material about structured products and so create greater acceptance about their potential.

The UK Structured Products Association is not a commercial organisation and education and research are its core activities.