

# EU PRIIPs Regulation – Relevance to Fund Managers Explained

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## Background

On 1 January 2018, European Union (EU) Regulation (No 1286/2014)[\[1\]](#) on key information documents for packaged retail and insurance-based investment products (PRIIPs) comes into force. It will require that a key information document (KID) be prepared for each PRIIP that is made available to "retail investors" within the territory of the EU from 1 January 2018.

There are ongoing requirements that also apply under the PRIIPs Regulation, such as the need for the KID to be published on the website of the product manufacturer (i.e., the fund manager or the fund). The Regulation and requirements do not apply to products that were made available to retail investors within the territory of the EU up to 31 December 2017 but ceased to be available to retail investors after this date.

For example, a fund operating through commitment agreements and subsequent drawdowns would not have to produce a KID for drawdowns made on or after 1 January 2018 in circumstances where the commitment agreement was signed by the retail investor prior to that date. Equally, where contractual terms and conditions allow for exiting the PRIIP on or after 1 January 2018, but that PRIIP is no longer made available to other retail investors from this date, a KID would not be required. A KID would, however, need to be prepared if a retail investor within the territory of the EU sought to increase or 'top-up' his, her or its investment in a fund on or after 1 January 2018.

## What is a PRIIP?

Broadly, a PRIIP is an investment which, regardless of its legal form, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets that are not directly purchased by the retail investor.

By way of example, the United Kingdom Financial Conduct Authority (FCA) has stated that in its view the following investments would fall within the PRIIP definition:

- regulated collective investment schemes or unregulated collective investments schemes (this would include alternative investment funds);
- shares or units in an investment company or investment trust;
- derivatives (including options, futures and contracts for differences);
- structured deposits;
- securities issued by certain special purpose vehicles (SPVs) or special purpose entities (SPEs) with variable returns; and
- debt securities (bonds, notes or debentures) where the amount repayable is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the investor.

The FCA also has stated that in its view the following would not fall within the scope of the PRIIPs definition:

- deposits (other than structured deposits);
- assets that are held directly by the retail investor, such as corporate shares or sovereign bonds;
- pension products – pensions that are recognised under national law as having the primary purpose of providing the investor with an income in retirement;
- debentures and other debt securities where the amount repayable to the retail investor is fixed;
- non-life insurance/general insurance; and
- life insurance that only pays benefits on death or incapacity due to injury, sickness or infirmity.

Although UCITS funds would be caught by the PRIIPs definition, there is a transitional exemption period available for such funds until 31 December 2019, whereupon a KID would need to be produced. This transitional exemption is also available to any non-UCITS funds offered to retail clients and which, according to the national rules of an EU Member State, already has an obligation to provide a key investor information document in accordance with the requirements of the UCITS Directive.

There is a lack of legal clarity on the treatment of carried interest or co-investment vehicles under the Regulation, and an established market view has yet to develop. Within its recitals, the Regulation states that it applies to products "*manufactured by the financial services industry to provide investment opportunities to retail investors*" and goes on to state that funds "*dedicated to institutional investors*" are excluded from the scope of the Regulation. As such, if the only retail investors participating in such vehicles are investors "internal" to the fund manager (e.g., executives or employees involved in the management of the fund manager), there is an argument that such vehicles are not "manufactured" to provide investment opportunities to retail investors, and on this basis no KID would need to be prepared. There has yet to be regulatory confirmation or guidance on this approach and so advice should be sought on a case-by-case basis.

One point that has been made clear from EU Commission guidelines[\[2\]](#) is that if a product, whose acquisition does not require payment by a retail investor, i.e., neither an initial payment nor any risk of future financial commitments, then this should not be considered an investment within the meaning of the Regulation and, therefore, no KID is required in this circumstance.

### **What does "made available" mean?**

There is no definition of "made available" under the Regulation. However, the interpretation of this term that is being applied by the market is a broad one, and it applies to PRIIPs that are offered to retail investors irrespective of whether the offer arose at the initiative of the retail investor or not. There is, therefore, no reverse solicitation exemption under the Regulation.

In terms of timing, the KID is a pre-contractual document and the Regulation requires that the KID must then be provided "in good time before the retail investors are bound by any contract or offer relating to that PRIIP". There is no regulatory guidance as to what is meant by "in good time" for these purposes; on a purposive interpretation, the KID should be provided to the retail investor at the same time as the subscription agreement is provided, if not before.

### **What is a "retail investor"?**

For the purposes of investment funds, the definition of "retail investor" under the Regulation applies to any investor who does not fall within definition of a "professional client" as defined in in the second Markets in Financial Instruments Directive (MiFID II).

The definition of "professional client" would generally cover EU institutional investors (such as banks, insurance companies, other authorised financial services firms, funds, collective investment schemes, pension funds (other than local authority-administered pension funds), family offices, national government and regional government entities), so offering to these types of investors would not trigger the requirement to produce a KID. However, in order for individuals within the territory of the EU or EU local authorities/municipalities (or the pension funds they may administer) to be categorized as "professional clients" they must be opted-up under the process specified in MiFID II. This requires, among other things, that the investor meet both qualitative and quantitative criteria.

Under the qualitative criteria, the investor must be assessed (taking into account the investor's expertise, experience and knowledge) and deemed to be capable of making his, her or its own investment decisions and understanding the risks involved with the transaction envisaged. Certain disclosures also are required to be made to the investor (normally through a standalone notice or letter).

Under the quantitative criteria, the investor would be required to meet at least two out of the three criteria set out below.

- The client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters;
- The size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500,000; and

The client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

The quantitative criteria can therefore be difficult for some individuals to meet. If they are unable to meet the relevant opt-up criteria, they must be treated as retail investors.

It should be noted that for EU local authorities/municipalities (or pension funds which they administer), some EU member states (such as the UK) have introduced specific opt-up criteria which local authorities in their jurisdiction must meet in order to be opted-up to professional client status. Where no specific criteria exists for opting-up local authorities/municipalities in a particular EU Member State, the standard MiFID II quantitative criteria should be applied.

### ***Extra-territoriality***

The Regulation applies in circumstances where a PRIIP (e.g., a fund investment) is made available to a retail investor within the territory of the EU. It does not matter where the offeror is based or from where the communication was made. The Regulation therefore applies to non-EU fund managers (or their agents) offering their funds to retail investors within the territory of the EU.

In contrast, where a PRIIP is only made available to retail investors outside the EU, no KID is required.

### ***What are the contents requirements of the KID?***

A KID must be a standalone document of a maximum of three sides of A4 paper and must be presented in language that is clear, succinct and comprehensive. It must be written in the official or any other accepted language of the EU Member State where the PRIIP is offered or sold. In addition, it must be translated into all corresponding official languages in which marketing documents are used. Any translation made must faithfully and accurately reflect the content of the original KID. The KID must contain the following information, presented in a predetermined sequence of sections. The sections are:

- What is this product?
- What are the risks and what could I get in return?

What happens if the PRIIP manufacturer is unable to pay out?

- What are the costs?
- How long should I hold it and can I take money out early?
- How can I complain?
- Other relevant information.

The Regulation and related delegated legislation sets out prescriptive requirements as to the contents of the KID. Some of the information within the KID is relatively straightforward. Some sections, however, involve more quantitative analysis and modelling that will require specialist input.

### **What are the penalties for non-compliance?**

Under the Regulation, it is left to each EU Member State to determine what administrative penalties and other measures could be imposed on firms for not complying with the requirements of the Regulation. The Regulation provides that EU regulators are able to make an order to the offending firm to cease marketing the PRIIP and/or issue a public statement indicating the person responsible for, and the nature of, the infringement. Equally, EU regulators are permitted under the Regulation to issue administrative fines of up to EUR 5 million or up to 3% of the offending firm's total annual turnover. The Regulation provides that sanctions and measures shall be effective, proportionate and dissuasive. There is no automatic investor right of rescission built into the Regulation; however, national law of a particular EU Member State may allow for such a remedy.

### ***What should firms be doing in preparation for the PRIIPS Regulation?***

The key starting point for fund managers is to determine whether it wishes to make its funds available to retail investors within the territory of the EU to invest in from 1 January 2018 onwards.

If it does, then it should take the appropriate steps to produce a KID ahead of the offer being made to the retail investor.

If it does not then the fund manager should take all steps necessary to ensure that its fund interests are not made available to retail investors within the territory of the EU.

This could include:

- Putting internal systems and controls in place to ensure that all relevant personnel within the fund manager are aware that the fund must not be offered to retail investors within the territory of the EU;
- Taking measures to ensure that it is not possible for retail investor within the EU to invest in the fund; for example, by including an EU investor schedule in a fund subscription agreement which makes clear that only investors meeting the professional client definition under MiFID II will be able to invest;
- Including relevant legends and selling restrictions in fund documentation that expressly state that the fund is not being offered or made available to retail investors within the territory of the EU; and
- Notifying any distributors, placement agent or sales teams, making it clear that the fund is not, to be offered or sold to retail investors within the territory of the EU.

Should you have further questions in relation to the Regulation and its requirements, please contact your Proskauer contact for more information.

[1] <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R1286&from=en>

[2] [http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017XC0707\(02\)&from=EN](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017XC0707(02)&from=EN)

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