

FCA consultation on proposed rules and amendments to PRIIPs regulation

Post-Brexit divergence in disclosure documents provided to retail investors under PRIIPs regulation

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In July 2021, the Financial Conduct Authority (FCA) published a consultation paper “[PRIIPs - Proposed scope rules and amendments to Regulatory Technical Standards](#)” (CP21/23) seeking stakeholders’ views on proposed amendments to existing European Union (EU) regulation¹ covering Key Information Documents (KIDs) for Packaged Retail and Insurance-Based Investment Products (PRIIPs).

Introduction

The EU regulation covering PRIIPs intended to make information about packaged investment products more transparent through requiring the production of standardised KIDs by sellers, producers or advisors of PRIIPs. The FCA’s [Call for Input](#) on stakeholders’ experiences of the PRIIPs regime in 2018 identified some major concerns with the PRIIPs regime. These included a lack of clarity regarding how PRIIPs are defined by the regulation, and potential for the KID to contain misleading information. Following the UK’s withdrawal from the EU on 31 January 2020, the Treasury introduced legislation² to enable the improvement of the functioning of the PRIIPs regime in the UK.

The FCA’s proposals included in this Consultation Paper (CP) aim to address the most serious concerns raised in the

responses to the Call for Input, and to advance consumer protection objectives, by:

- Clarifying the scope of the PRIIPs regulation (particularly for corporate bonds)
- Introducing guidance to clarify what it means for a PRIIP to be ‘made available’ to retail investors
- Changing the Regulatory Technical Standards (RTS)³ laid down in regulation [EU 2017/653](#) to mitigate the potential for inappropriate performance scenarios and Summary Risk Indicators (SRIs) being presented in the KID
- Amending the RTS to address concerns surrounding the transaction cost calculation methodology

EU firms manufacturing and marketing products in the UK will also be required to comply with the new UK PRIIPs regulation.

However, undertakings for collective investment in transferable securities (UCITS) schemes and non-UCITS retail schemes (NURS),⁴ although classified as PRIIPs, have been subject to an exemption from producing KIDs. This exemption is due to continue until 31 December 2026.⁵

Additionally, a new Overseas Funds Regime (OFR) will allow certain categories of non-UK funds to be marketed to retail investors in the UK: the FCA will consult on this separately, and PRIIPs requirements in this CP do not apply to OFR.

Market participants have until **30 September 2021** to submit their comments regarding the FCA’s proposals. The FCA intends to make final rules before the end of the year, with the rules coming into effect on **1 January 2022**.

This paper, drafted by Milliman consultants in the UK, aims to summarise the key aspects of the consultation.

¹ Regulation (EU) No 1286/2014 on key information documents for packaged retail and insurance-based investment products: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R1286>.

² See Section 38 of the Financial Services Act 2021.

³ The PRIIPs RTS set out the detail of and methodology for the information which must be disclosed in the KID.

⁴ If a NURS-KII document is used instead of a PRIIPs KID/

⁵ See <https://www.gov.uk/government/news/announcement-hm-treasury-to-extend-priips-exemption-for-ucits-funds-for-five-years>.

Proposed Rules

CLARIFYING THE SCOPE OF THE PRIIPS REGIME IN THE UK

Proposed scope of rules

The definition of a PRIIP is uncontroversial for many investment products where it is obvious if that product meets / fails the definition (e.g., investment funds clearly meet the definition whereas conventional non-profit insurance products do not). However, the FCA stresses that for some investments, particularly in the corporate bond market, there is ambiguity as to whether the product meets the definition and therefore is in-scope of the PRIIPs regulation.

According to the CP, some issuers have suffered the cost of producing the KID despite there being no requirement for them to do so. On the other hand, some distributors have prevented retail investors from accessing investment products to avoid the firm being legally responsible for failing to supply a KID in the event that the product is deemed to be a PRIIP. This may have led to some reduction in the liquidity and choice in the retail market for corporate bonds. In addition, there is uncertainty whether legacy products issued before the regulation came into force in January 2018 are within the scope of the PRIIPs regulation.

To address this issue, the FCA has proposed to clarify precisely which features make a corporate bond a PRIIP. The proposal intends to distinguish between corporate bonds which “*contain features that introduce a degree of variability or uncertainty to the overall return to investors, but which are properly viewed as non-packaged, direct investment in the business of the issuer*” and corporate bonds where “*the overall return to investors is substantially determined by the performance of investment assets the investor does not purchase, or which are better regarded as a packaged investment due to their complex features.*” The FCA goes on to explain which specific types of debt securities are not regarded as PRIIPs. Clarifications include that debt securities are not PRIIPs due to the following features alone: having fixed coupons, being puttable or callable, or having a perpetual or indefinite term.

Finally, the FCA makes it clear that legacy products issued before 1 January 2018 are not PRIIPs.

Proposed “made available” advice

Under the PRIIPs regime, firms are only required to produce and publish a KID where a PRIIP is ‘made available’ to UK retail investors. However, a number of stakeholders have commented that they are burdened with the costs of producing a KID (or the potential legal risks relating to not producing a KID) where their product is not intended for retail clients, but could potentially be sold to retail investors, for example on a secondary market.

The FCA’s proposed guidance sets out the conditions they consider to be sensible and proportionate in order to ensure that a PRIIP is directed away from retail investors. These are that:

- The marketing materials for the product make it clear that it is being offered only to investors eligible for categorisation as professional clients or eligible counterparties, and that it is not intended for retail investors.
- The PRIIP’s marketing and distribution strategy is aimed at professional and eligible counterparty clients and not retail clients.
- The financial instrument is issued at a minimum denomination value of £100,000.

PROPOSED CHANGES TO PERFORMANCE AND RISK

Background

The PRIIPs RTS set out the detail of, and methodology for, the information which must be disclosed in the KID. They also specify how the information must be presented. However the presentation of the performance scenarios and the Summary Risk Indicator (SRI) can result in misleading information for some products.

The FCA is concerned about the risk of harm to retail investors who may base their investment decision on optimistic or biased performance scenarios, or on information that suggests the product is lower risk than it should reasonably be considered to represent. These unintended consequences of the RTS undermine the aims of the regime to provide accurate, clear, fair, and not misleading information.

Proposal to remove performance scenarios from KIDs

Significant concerns have been raised that the current methodology for calculation and presentation of performance scenarios can produce misleading illustrations, across almost all asset classes. The issue is primarily caused by the pro-cyclical nature of the methodologies; these use historical data to generate potential returns under various market conditions.⁶ Given market conditions prior to the introduction of the PRIIPs regime, many KIDs show performance illustrations which appear extremely over-optimistic in current conditions.

The Financial Services Act 2021⁷ removed the reference to ‘performance scenarios’ and instead provides a more flexible requirement of ‘information on performance.’ This allows the FCA to explore options for how PRIIPs manufacturers can produce and present performance information.

The FCA is proposing to remove the requirement for PRIIPs manufacturers to display performance scenarios in the KID. Instead, PRIIPs manufacturers would be required to describe narratively the factors that could materially influence future performance.

⁶ There are: stress, unfavourable, moderate, and favourable.

⁷ See Section 38 of the Financial Services Act 2021 (29th April 2021).

Furthermore, PRIIPs manufacturers would need to disclose the most relevant index, benchmark, target, or proxy, and an explanation of how the PRIIP is likely to compare, in terms of performance and volatility. An explanation of a favourable, negative, or worst scenario for the investment would also need to be included.

Consumer testing⁸ will be carried out alongside this CP to test consumer understanding and the impact of these proposed changes on choices made.

The FCA is not currently proposing to require inclusion of past performance alongside this narrative information, noting that not all investments will have (or have enough) historical data. It is, however, seeking views on whether the display of past performance in addition to the proposed narrative information would be helpful to consumers and their investment decision. To illustrate what this might entail, the FCA has included Indicative drafting for past performance (in square brackets) within the draft RTS in this CP.

Proposals to mitigate misleading summary risk indicator

The SRI is a standardised score between 1 and 7 and is based on the product's assessed market and credit risk. It is supplemented with a narrative explaining any limitations and any risks not captured in the SRI. Concerns have been raised that SRIs produced under the current methodology may underestimate the overall level of risk. This is particularly the case for illiquid assets.

Therefore, the FCA is proposing to introduce a requirement for PRIIPs manufacturers to upgrade their product's SRI if they believe that the rating produced by the RTS methodology is too low. PRIIPs manufacturers would be required to notify the FCA (by email) if they do upgrade their products' SRIs.

In addition, the FCA is proposing to require that PRIIPs issued by Venture Capital Trusts (VCTs) must be assigned an SRI score no lower than 6, meaning that the RTS methodology for the SRI will no longer be applied. This requirement is prompted by findings that around 70% of VCT investments had an SRI of 3, despite these types of investments being widely viewed as high risk.

Lastly, it is proposed that the current RTS 200-character limit for explaining all other significant risks not covered in the SRI score calculations is increased to 400 characters.

⁸ Results to be published alongside the Policy Statement.

⁹ Defined by the FCA as "the difference between the price at which a trade is executed and the 'arrival price' when the order to trade is transmitted to the market. It captures the bid-ask spread, as well as what is called the market impact."

¹⁰ The FCA previously covered this in section 2.23-2.24 of PRIIPs Call for Input Feedback Statement FS19/1.

PROPOSED CHANGES TO TRANSACTION COSTS

Background

The final area in which the FCA proposes changes is transaction costs, relevant to the "What are the Costs?" section of a KID. The methodology for calculating transaction costs may also be referred to as 'slippage.'⁹ The FCA has reiterated¹⁰ in this CP that they believe that the current slippage methodology is working as intended and is the best way to calculate transaction costs for the majority of products. CP21/23 then addresses concerns arising in three particular areas with respect to transaction costs:

- Anti-dilution
- Calculation of costs of over-the-counter (OTC) transactions in bonds
- Calculation of costs of index tracking funds

Transaction cost proposals

For PRIIPs where the benefit of anti-dilution¹¹ mechanisms is greater than the total transaction costs incurred, the anti-dilution benefit should not be included in the reporting of transaction costs, thus preventing the presentation of negative costs.¹² Additionally, firms using an anti-dilution mechanism should report the consequential benefits in the narrative description section for transaction costs. The value of this change is in promoting transparency over the makeup of costs.

Price availability can be an issue for debt securities, particularly OTC transactions in bonds. Currently, the PRIIPs requirement is to use the market mid-price at the time the order was transmitted to another person for execution. The FCA's interpretation of this is that the firm will need to verify the fairness of a price, prior to making the transaction, with the best evidence for the market mid-price of the bond being the average of the best bid and best offer found when obtaining quotes from multiple counterparties.

Index-tracking funds typically transact infrequently, and in large volume, and therefore slippage is not necessarily the best way of calculating costs for these types of funds. The FCA considers a spread model a better approach to calculating costs for index-tracking funds. For costs associated with auction orders, the arrival price should be determined as the mid-price immediately prior to the auction. For costs associated with orders effected at predetermined times, the arrival price should be calculated at that pre-determined time.

¹¹ The practice of passing on costs incurred through buying (selling) investments onto incoming (outgoing) investors.

¹² This approach would be consistent with COBS 19.8.22R, which applies to workplace pensions transaction costs.

Further minor amendments to the RTS include:

- Clarifying that when calculating transaction costs, the FCA considers that firms should calculate costs for the three-year period and take the average for the total period (rather than taking the rolling average of annual transaction costs).
- Clarifying the methodology to be used for transaction costs for PRIIPs that have been sold for less than three years.
- Where open or close prices lead to misleading results, allowing use of the most recent available price or a 'justifiable' independent price.

Overall Considerations

These proposals will certainly be welcomed by many firms which feel that the PRIIPs regime is unduly onerous, whilst also resulting in documents which potentially misinform retail investors. The removal of performance scenarios will particularly reduce the workload and cost involved in producing a KID for a given product. The changes to performance information and the SRI should mitigate the risk of retail customers failing to identify the most appropriate product for their risk appetite and reduce the risk of mis-selling issues arising.

Removal of the current RTS performance scenario methodology would mark a significant divergence from the EU requirements. It will therefore result in a firm operating in both the UK and the EU having to produce two separate documents under different methodologies.

The changes to the SRI may well mitigate the risk of consumer harm for products which are obviously assigned ratings that are too low, but for those where the accuracy of the risk rating is less clear, firms may be in significant doubt as to how to approach the new rules (should they be confirmed). Such grey areas are likely to cause confusion to firms and it may take time for market practice to emerge. The proposals from the FCA do not address the underlying cause of the problems with the SRI methodology. It is unclear whether the FCA intends to amend the methodology for calculating the SRI in the longer term.

Similarly, the proposal to introduce a narrative regarding performance puts significant responsibility on firms to decide how and what to include in the disclosures. This could result in a wide variety of approaches being used. This appears to go against one of the aims of the PRIIPs regulation, being to provide standardised information to investors so that they can compare investments.

Firms may also be concerned that the level of flexibility in the proposals introduces conduct risks. For example, SRIs could remain too low if there is not a clear cut rule to specify that a rating should be higher. To avoid such risks, firms may be motivated to report a higher SRI. This would contradict the principle of providing accurate information and information which is not misleading.

Despite these potential concerns, both customers and firms should see benefit from these proposed changes. Firms will however need to carefully assess how they approach the changes with respect to performance information and the SRI.

How Milliman Can Help

Milliman would be happy to discuss with firms how best to approach the proposed changes to the KID documents and PRIIPs regime. We can offer a range of support to assist firms, including:

- Assisting in assessing the material factors driving performance returns, relevant to the proposed performance information section of the KID
- Assessing to what extent a product SRI should be reviewed

Please get in contact with your usual Milliman consultant if you wish to discuss further.

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