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The EU PRIIPs Regulation for Fund Managers

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Background

With the vast majority of European Union (EU) regulatory focus recently having been on the Markets in Financial Instruments Directive (MiFID II), it is important not to overlook the impending implementation of the EU's Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs Regulation)[1]. The PRIIPs Regulation is part of the wider EU and EEA[2] regulatory reform following the financial crisis; it is directed at providing EEA retail investors with transparency when investing in structured and other packaged products (including most regulated and unregulated funds). The PRIIPs Regulation will go into effect on January 1, 2018.

All fund managers, both EEA and non-EEA, are advised to consider whether their funds have any EEA retail investors (and are therefore subject to the PRIIPs Regulation) or wish to preserve the option to take in EU retail investors (and therefore will be subject to the PRIIPs Regulation if they admit a EU retail investor).

PRIIP

A PRIIP is an investment, whatever its legal form, where 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. Examples include funds (whether UCITS funds[3] or alternative investment funds (AIFs) under the Alternative Investment Fund Managers Directive (AIFM Directive)); shares or units in an investment company or investment trust; all 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.

Requirements

The PRIIPs Regulation requires that the "manufacturer" of an investment (such as the manager of a fund) that is "made available" to an EEA retail investor[4] must make a key

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[1] Regulation (EU) No 1286/2014, *Official Journal of the European Union*.

[2] The PRIIPs Regulation applies in all EU member states and the European Economic Area states of Norway, Iceland and Liechtenstein (EEA). For the purposes of this note, "EEA" means all such EU and EEA states.

[3] i.e., EU/EEA mutual funds under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directives.

[4] It should be noted that where a PRIIP is made available only to retail investors outside the EEA, the PRIIPs Regulation has no effect.

information document (KID) available to such EEA retail investors "*in good time before the retail investors are bound by any contract or offer relating to that PRIIP*." (There is no guidance on what "in good time" means, though the point in time before execution of subscription documents is considered by the market to be the cut-off time).

Unfortunately, "made available" also is not defined in the PRIIPs Regulation, though the market view is that it should be construed very broadly—so *any* PRIIPs that are offered to EEA retail investors are in scope—whoever offers them—whether the manager, a distributor or a third party, whether at the manager's initiative, pursuant to a reverse solicitation or otherwise. KIDs must be in a prescribed[5] three-page format, setting forth information on costs, risks and rewards, according to set methodologies.

Institutional fund managers will not generally be marketing/making available their funds to EEA retail investors[6] and in all likelihood will not wish to have to prepare KIDs given the cost and complexity of doing so. Failing to do so in circumstances where the PRIIPs Regulation applies could be costly as EEA regulators have the power under the PRIIPs Regulation to issue fines of up to EUR 5 million or up to 3 percent of the manager's total annual turnover.

Retail Investors in the EEA

A retail investor for the purposes of the PRIIPs Regulation is a "retail client" as defined under MiFID II—being any client that is not a "professional client." The category of "professional client" includes most institutional investors—such as regulated financial institutions, most pension funds, governments, central banks and certain large entities. The category does not include natural persons investing in their personal capacity. However, significantly, MiFID II (as has been the case for the past 10 years under MiFID I) also has what is known as an "opting-up" process so that highly knowledgeable, high-net worth retail investors (for example) may elect to be treated as professional clients (see below).

In addition, from January 3, 2018 (when MiFID II takes effect) local authorities/municipalities are to be "downgraded" from professional client status to retail client status—as the EEA authorities consider that they should naturally be afforded extra protection under the EEA regulatory system.

Consequently, any managers with high-net worth individuals, UK local authority pension funds or EEA local authorities/ municipalities as investors should therefore be aware that such investors must be treated as retail investors for the purposes of the PRIIPs Regulation, *unless* **each** such **investor** affirmatively elects to be treated under the opting-up procedure as an "elective professional client" prior to having its subscription accepted by a fund.

The PRIIPs Regulation does not have retroactive effect and, therefore, managers who *already* have high-net worth individuals, UK local authority pension funds or EEA local authorities as investors in their funds will ***not*** need to either (a) provide a KID to such investors; or (b) opt-up those investors to elective professional client status unless any such investor requests an additional subscription to a fund in which they are already invested, or they wish to invest in a new fund.

For a person that would otherwise be a retail client to be able to treated as a professional client (either generally or in relation to one or more specific trades/services/products), they must be assessed under quantitative and qualitative tests:

The **qualitative test** requires that an investment firm assesses the person's expertise, experience and knowledge to determine their capability to make their own investment decisions and to understand the risks involved with the transaction envisaged.

The **quantitative test** requires assessing the person to ensure that they meet at least two out of the three following criteria:

- they have carried out transactions, in significant size, on the relevant market at an average frequency of 10-per-quarter over the previous four quarters;[7]

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[5] Commission Delegated Regulation (EU) 2017/653, *Official Journal of the European Union.*

[6] It should be noted that under the AIFMD there are tight restrictions and regulatory compliance requirements that must be complied with for the marketing of AIFs in the EEA—including a general prohibition on the marketing of AIFs to retail investors, with any AIFMD-compliant marketing being directed only at EEA professional investors. Equally, if a manager is responding to a reverse solicitation request from an EEA investor, such an investor *must* be a professional investor. Marketing of AIFs to retail investors in EEA member states is subject to additional country-specific rules.

[7] In an exclusively fund context, it seems unlikely that a high-net worth individual, or a UK local authority pension fund, or EEA local authority/municipality would make investments into funds with an average frequency of 10-per-quarter over the previous four quarters. As a result, to safely satisfy the elective professional client quantitative test, investment firms will generally seek to satisfy the asset value test and the experience of work in the financial sector test.

- their financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 500,000*; and/ or
- they work or have worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

*For UK local authorities/municipalities (or pension funds which they administer), the UK Financial Conduct Authority has introduced a specific net asset value threshold of GBP £10 million, which local authorities in the UK *must* meet in order to be opted-up to elective professional client status (assuming that they also meet either the first bullet point, or the last (which in the context of the local authority etc. is applied to the person authorised to carry out relevant transactions)). If other EEA countries do not introduce specific new, jurisdiction-specific criteria, the MiFID II quantitative criteria set forth above have to be adhered to.

If a person meets the relevant requirements, the investment firm/fund manager (whether in the EEA, the United States or elsewhere[8]) conducting the opt-up process must make certain disclosures to the person and obtain their explicit consent to being treated as an elective professional client, with provision to the person also of information on the regulatory protections that they will lose as a result of being opted-up to elective professional client status. If the person cannot meet the tests, they must be treated as retail investors.

Action Points

Managers who do ***not*** wish to prepare a KID for any funds that they wish to make available to retail investors in the EEA should consider the following:

1. putting in place procedures, systems and compliance controls (directly or via the fund's administrator) to ensure that any EEA retail investors cannot invest in their funds on or after January 1, 2018;
2. ensuring that any high-net worth individuals, UK local authority pension funds, or EEA local authorities/municipalities that are potential investors in a fund (or existing investors seeking to add to their investment) are opted-up to professional client status before any further EEA marketing or investment activities take place with such potential investors on or after January 1, 2018;
3. providing a clear prohibition to distributors and placement agents that the fund may not be marketed to/made available to EEA retail investors; and
4. adding disclosure (in the form of an additional regulatory legend) to funds' private placement memorandum (PPM) and subscription documents (Sub Docs) so as to be explicitly clear that the fund interests are only being made available in the EEA to professional clients, as defined in MiFID II.

Quick Q&A

- *Does the PRIIPs Regulation apply on a potential investor by investor basis?* Yes.
- *Is there a filing to be made with the FCA or any other EEA/EU regulator by US managers?* No.
- *We have EEA-based individual investors in our funds. Do we have to compulsorily redeem them/enforce mandatory redemption? Do we have to ensure that they are opted-up?* No on both. If they are already in the fund and you are not marketing to them, the PRIIPs Regulation will not be relevant until and unless that investor seeks to add to its investment. The PRIIPs Regulation only applies where you are "making available" fund interests to EEA retail investors on or after January 1, 2018.
- *Should we prohibit EU/EEA retail investors going forward?* This is a commercial decision; if you did wish to put such a prohibition in place it would be advisable to have procedures in place as well as adding a legend in the relevant fund's PPM and Sub Docs, with no need to consider any KID or opt-up issues further. If you do not, you will need procedures, a legend in the PPM and Sub Docs, and a clear process to perform opt-ups for such investors in accordance with EEA requirements.

[8] Although not entirely without doubt, the general market view (absent any regulatory guidance to the contrary) is that non-EU investment firms can conduct the opt-up process—as long as they adhere to the mandated MiFID II process.

- *Is it correct that the PRIIPs Regulation also applies to investors that invest through intermediaries or custodians?* It depends. If the intermediary or custodian is simply acting as agent for the retail investor, and the ultimate investment is to be made by the retail investor (with fund interests "made available" to the retail investor), then yes, the PRIIPs Regulation applies and the intermediary or custodian will have the direct obligations to ensure that the rules are satisfied in the EEA. However, if a retail investor invests in an investment structure whereby a separate legal entity is interposed between the investment structure and the investor, such as an anonymous/ aggregated nominee vehicle managed by a bank, then (a) the interests in the vehicle itself may be a PRIIP; and (b) if the fund interests are not "made available" to the retail investors, then the PRIIPs Regulation should not apply to the nominee vehicle making the investment if it satisfies the professional investor requirements.
- *What happens if an EU/EEA retail investor gets a PPM before it has been opted-up?* The firm's procedures, systems and compliance controls (directly or via the fund's administrator) should ensure that any EEA retail investors are unable to make a subscription on or after January 1, 2018 without the opt-up process being satisfied.

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