Setting the global standard for investment professionals

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Register of Interest
Representatives:
ID # 89854211497-57

31st January 2011

Dear Mr. Bassi,

Re: Consultation legislative steps for the Packaged Retail Investment Products initiative

Executive Summary

CFA Institute appreciates the opportunity to express its views on the proposals and considerations set out in the working document of the Commission services regarding legislative steps for the Packaged Retail Investment Products (PRIPs) initiative.

- We support the work of the Commission to resolve information asymmetries and principle/agent issues in the marketing of retail investment products.

- We believe the scope of the PRIPS regime should be as broad as possible in order to capture all retail investment products (as distinct from savings products) with packaged, wrapped or derivative characteristics. This includes pensions and annuity schemes, including those marketed under an insurance wrapper.

- We support the introduction of a new cross-sectional instrument to govern pre-contractual product disclosure and rules on selling. We think elements from MiFID and the UCITS Directive will make investors better informed and offer much needed protection.

- Comparability between all retail investment products will be a significant achievement. Hence, we urge the Commission to commit to the creation of a universal Key Investor Information Document (KIID). Whilst we recognise this presents a significant challenge, this challenge was met and overcome in the creation of the specification of the KIID for UCITS.

Our response to the consultation's specific questions is set out below. Please do not hesitate to contact us, should you wish to discuss any of the points raised.

Yours faithfully,

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CFA Institute is a global, not-for-profit professional association of more than 102,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 135 countries, of whom more than 91,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories. We have close to 13,000 members resident in the European Union.

CFA Institute develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). CFA Institute is best known for developing and administrating the Chartered Financial Analyst® curriculum and examinations and issuing the CFA Charter.

1. *Scope of the PRIPs Regime*

1.1. Proposed solution

<u>Questions 1-5:</u>

1. *Should the PRIPs initiative focus on packaged investments? Please justify or explain your answer.*
2. *Should a definition of PRIPs focus on fluctuations in investment values? Please justify or explain your answer.*
3. *Does a reference to indirectness of exposure capture the 'packaging' of investments? Please justify or explain your answer.*
4. *Do you think it is necessary to explicitly clarify that the definition applies to fluctuations in 'reference values' more generally, given some financial products provide payouts that do not appear to be linked to specific or tangible assets themselves, e.g. payouts linked to certain financial indices, the rate of inflation, or the overall value of a fund or business?*
5. *Do you have any other comments on the proposed definition? If you consider it ineffective in some regard, please provide alternatives and explain your rationale in relation to the criteria for a successful definition outlined above.*

1. CFA Institute favours a broad definition of PRIPs, to capture all types of retail investment products, both existing and future, under the scope of the envisaged directive. The aim should be to offer investors a high and homogenous level of protection for *all* retail investor products. We are disappointed that the Commission has abandoned the preceding nomenclature of Substitute Retail Investment Products (SRIPs) in favour of the more narrow definition Packaged Retail Investment Products (PRIPs).

2. We support inclusion of the word 'fluctuations' as it is a key word that defines a PRIP (see box below). The word fluctuation incorporates the concept of risk, which distinguishes these products as investment products as opposed to savings products. The Commission should consider carefully that some products labelled as savings products, are in practice investment products because their risk characteristics exceed those of normal bank deposits.

3. We support the concept of 'indirectness' when defining a PRIP, while including direct holdings through 'combination or wrapping'. The direct holding of assets through an intermediary vehicle explicitly captures many products. However, there are others whose performance depends on reference to a basket of assets, where the intermediary does not hold the underlying, but makes a pledge to offer the performance characteristics of the underlying to the investor. Our hope is that through the concept of indirectness the Commission will capture products whose returns are determined by reference to an asset rather than physically holding the underlying asset; in other words derivative contracts underwritten by the product manufacturer.

4. Yes, we agree that it is appropriate to refer to 'fluctuations in references values' as this incorporates both cash and derivative instruments.

5. The definition appears to cover the area of concern. However, we would like to see greater clarity on what is meant by "other mechanisms". This is a key phrase which determines what 'non-wrapped' products are brought under the scope of the proposals. We are keen to make sure the definition covers returns/payments that are associated with derivative based products that may not explicitly be called derivatives.

Definition of PRIP:

> *A PRIP is a product where the amount payable to the investor is exposed to fluctuations in the market value of assets or payouts from assets, through combination or wrapping of those assets, or other mechanisms than a direct holding.*

1.2. Clarifying the definition: Possible Exceptions

Deposits

Questions 6-8:

6. Should simple (non-structured) deposits be excluded from the scope of the initiative? Please justify or explain your answer.

7. Do you consider option 1 or option 2 preferable for achieving this? Please explain your preference, and set out an alternative if necessary, with supporting evidence.

8. Should such an exclusion be extended to financial instruments which might raise similar issues as deposits (e.g. bonds), and if so, how might these be defined? Please justify or explain your answer.

6. We support the proposal when the product is indeed simple and non-structured. We consider non-complex deposits as savings products.

7. We support option one. While complex, it captures deposit instruments with derivative characteristics (see box below).

8. We believe bonds should be included in the definition of a PRIP if the fall under the option one definition, essentially these are bonds whose return is defined by derivative style returns. However, simple bonds or notes, without a packaging element, should fall outside the scope of the proposals.

<u>Option 1</u>

A deposit shall be a PRIP where [it is fully repayable, on terms under which] any interest or premium will be paid (or is at risk) according to a formula which involves the performance of:

- *an index or combination of indices, excluding variable rate deposits whose return is directly linked to e.g. EURIBOR, LIBOR or another interest rate index;*
- *a MiFID financial instrument or combination of such financial instruments;*
- *a commodity or combination of commodities; or*
- *a foreign exchange rate or combination of foreign exchange rates.*

<u>Option 2</u>

A deposit shall be a PRIP if either of the following conditions are met:

- *its principal is not repayable at par;*
- *its principal is only repayable at par under a particular guarantee or agreement provided by the credit institution or a third party.*

Pensions

<u>Questions 9-12:</u>

9. Should pensions be explicitly excluded from the PRIPs initiative at this stage? Please justify or explain your answer.

10. Should annuities be treated in the same fashion? Again, please justify or explain your answer.

11. Do you have any comments on the proposed manner of achieving this exclusion?

12. Do you agree that variable annuities might need to be treated as a special case? If so, how should these be defined, and how do you think they should be addressed?

9. Pension funds share similar characteristics with investment funds. The only differences being the tax treatment of returns and the timing of when the investor receives the return on and return of his investment. Excluding pension funds would undermine the spirit of the proposals and create opportunities for regulatory arbitrage. Hence, we strongly resist proposals to exclude pensions from the scope of the proposals.

10. No annuities should be covered under the proposals. Saving to buy an annuity is effectively the same as investing in a pension. Investor disclosure in this area is very poor, particularly in regard to charges.

11. No comment

12. No comment

1.3. Clarifying the definition: Use of indicative lists of products

Questions 13-14:

13. Do you see benefits from such an indicative list being developed? If not, please provide alternative proposals and evidence for why these might be effective.

14. Do you have any suggestions on the possible contents for such a list, including on how to define items placed on the list?

13. We agree clarification of the definition needs to take place at a secondary level. The layered approach using principles and an indicative list of products covered by the directive can prove a useful tool for reducing legal uncertainties. It is however important that this list is not perceived as being exhaustive. An exhaustive list would create an incentive to ‘game’ the spirit of the proposals, making any list obsolete over time. Hence, we believe that the indicative list needs to be prefaced by guiding principles in order to maintain the desired level of investor protection.

14. We do not have any suggestions at this stage; we would certainly be interested in contributing to the level 2 discussions at a later date.

2. Legislative approach to be taken in delivering the PRIPs regime

2.1. Sales rules

The Commission services propose using both the IMD and MiFID to deliver the PRIPs initiative on sales rules, retaining these two distinct regimes, but aligning sales rules for PRIPs on the benchmark of MiFID.

The approach being considered would:

- *Expand the application of MiFID sales rules to cover those PRIPs other than insurance PRIPs that might currently be not covered (e.g. structured deposits) [see MiFID review consultation];*
- *Ensure that MiFID sales rules apply to all sales of PRIPs under MiFID, even where an exemption might otherwise apply [see MiFID review consultation];*
- *Introduce into the IMD rules on sales of PRIPs that are consistent with those in MiFID (rules on conflicts of interest and on conduct of business) [see the IMD review consultation]; and*
- *Make changes to the UCITS framework to ensure direct sales by UCITS asset managers are fully subject to MiFID sales rules.*

Questions 15-16:

15. Should direct sales of UCITS be covered by means of including the relevant rules within the UCITS framework?

16. Do you have any comments on the identified pros and cons of this approach, and any evidence on the scale and nature of impacts (costs as well as benefits)?

15. We fully agree with the Commission's proposal to create a cross-sectional instrument of pre-contractual disclosure and sales rules for PRIPS. Integrating the UCITS and MiFID frameworks into the PRIPS directive would achieve the desired level of investor protection. The MiFID conduct of business, sales and conflicts rules should apply to all retail investment products covered by the PRIPs directive, where our main concerns lie with suitability and transparency. For investment products wrapped under insurance policies, the MiFID rules should also apply, again to achieve the desired level of investor protection, across all retail products.

16. No comment

3. A new pre-contractual product disclosure instrument

3.1 Possible content of new regime

a) Principles underlying the design of the regime

<u>Questions 17-19:</u>

17 Should the design of the KIID be focused on delivering on the objective of aiding retail investment decision making? If you disagree, please justify or explain your answer.

18 Should the KIID should be a separate or 'stand alone' document compared with other information that might be necessary, e.g. background information, other disclosures, or contractual information? Please justify or explain your answer.

19 What measures do you think will be necessary to ensure KIID remain streamlined and focused solely on key information?

17. We strongly agree that the KIID for PRIPS should enable investors to make informed investment decisions. CESR (now ESMA) has done an excellent job with KIID for UCITS. The KIID template for UCITS ought to be extended to all retail investment products.

18. We believe the KIID should be a short, focused stand-alone document, just like KIID for UCITS. The KIID should concisely convey the strategy of the investment vehicle, expected risk/return characteristics, charges and past performance where applicable. On reading this document the investor should be able to form a strong view on whether to reject or purchase the investment, or seek further guidance through advice or a prospectus. The KIID should be a significant filter in the decision making process.

19. The KIID for PRIPS needs to be streamlined and focused; the information contained within should only describe the unique investment characteristics of the product, but this information should be set in a prescribed order. All investment products have common features which make them comparable: investment strategy, expected risk/return and charges. Products with a history can provide past performance. Generic information that is common to all products, particularly descriptions of the meanings of the above characteristics should be paired back to minimum to free up space for product specific information. We suggest that placing all generic information on another two—page document that follows the form of the KIID - in essence a 'key' for the KIID, would further improve the investor's experience.

b) Level of standardisation

<u>Questions 20-24:</u>

20. While the same broad principles should be applied to all PRIPs, should detailed implementations of some of these principles be tailored for different types of PRIP? Please justify or explain your answer, and provide examples, where relevant, of the kinds of tailoring you might envisage.

21. Do you foresee any difficulties in requiring the KIID to always follow the same broad structure (sequence of items, labelling of items)? Please justify or explain your answer.

22. Do you foresee any difficulties in requiring certain parts of the key information and its presentation (e.g. on costs, performance, risks, and guarantees) to be standardised and consistent as possible, irrespective of tailoring otherwise allowed? Please justify or explain your answer.

23. Can you provide examples and evidence of the costs and benefits from your experience that might be expected from greater standardisation of the presentation and content in the KIID?

24. Should the content of the KIID be controlled so that there is no possibility for firms to add additional information unless expressly allowed for?

20. No, we would not support detailed implementations that would spawn different types of KIID. The most important feature of the KIID is that an investor should be able to seamlessly compare products through one consistent template.

21. We do not foresee any difficulties in requiring a prescribed structure for the form of the KIID. The salient features of investment products are, strategy, risk/reward and charges, these characteristics are universal across all investment products.

22. The development of the KIID for UCITS has met and largely overcome these challenges. While not perfect, we believe that the KIID can evolve further through the process that will make it applicable for PRIPS. For example, we would like to see more refinement in the synthetic risk return indicator.

23. No comment

24. Yes, we believe the content should be controlled.

c) Content of PRIPs KIIDs

<u>General requirements sitting at level 1</u>

- *KIID must be 'fair, clear and not misleading'.*
- *KIID must be short – 2 pages where possible, exceptions to be outlined in detailed implementing measures.*

- *KIID must be written in plain language suited to the target retail investor.*
- *KIID must be presented in an appealing and consumer-friendly manner.*
- *KIID must focus on key information, as necessary for the average investor to make an informed decision on the PRIP in question.*
- *KIID must include, as relevant for the PRIP, information on:*
    - *The identification of product and who has produced it;*
    - *What the product is and how it works – the basic investment proposition;*
    - *The nature / limits of any features provided, including the nature / limits of any guarantees offered.*
    - *The broad 'risk / reward' proposition represented by the product;*
    - *The costs of the product;*
    - *The performance of the product (where it has a track record) or information about possible performance scenarios (where relevant);*
    - *Practical information (such as information on compensation schemes, on finding the value of the investment, on subscribing to or redeeming an investment, on finding further information, etc).*

    [Detailed implementing measures will be specified at L2 or through technical standards across these different areas, varying as necessary between different classes or type of PRIP]

- *KIID must be provided to retail clients using a durable medium that is appropriate to the context / manner of the proposed sale of the PRIP.*
- *KIID must be kept 'up to date' and accurate, so that investor can rely on it without reference to other information.*

Questions 25-26:

25. Do you foresee and difficulties in applying these broad principles to the KIID for all PRIPs, as the building blocks on content and format for a 'level 1' instrument? Please justify or explain your answer.

26. Are there any other broad principles that should be considered on content and format?

25. No, we believe these are practical principles that will help investors make informed decisions.

26. We have nothing to add.

d) Allocation of responsibilities for production of KII

Questions 27-29:

> 27. *Should product manufacturers be made generally responsible for preparing a KIID? Please justify or explain your answer.*
>
> 28. *Are you aware of any problems that might arise in the distribution of particular products should responsibilities for producing the KIID be solely placed on the product manufacturer?*
>
> 29. *If intermediaries or distributors might be permitted to prepare the documents in some cases, how would these cases be defined? Do you foresee and difficulties in applying these broad principles to the KIID for all PRIPs, as the building blocks on content and format for a 'level 1' instrument? Please justify or explain your answer.*

27. We believe that the manufacturer is best placed to produce the KIID for PRIPS, as the manufacture is the first source of information on the characteristics of the product. We are disinclined to let others produce the KIID, because their information will be derived from the manufacturer. We understand that distributors bid for certain structured products; the winning bid will set the risk/return characteristics. Therefore, in certain circumstances, both parties should share information to facilitate the drafting of the KIID.

28. Yes, we recognise there will be difficulties in producing the KIID, particularly where there is an unaccounted fee or commission, which is charged by the distributor but not reflected in the KIID.

29. Only in 'very' exceptional circumstances would we support the possibility for intermediaries and distributors to produce the KIID. We think this problem is overcome by collaboration between manufacturer and distributor, with the manufacturer retaining control of the final document.

e) Labelling and enhanced transparency of PRIPs in relation to socially responsible investments

> *Questions 30-31:*
>
> 30. *What detailed steps might be taken to improve the transparency of the social and environmental impacts of investments in the KIID for PRIPs?*
>
> 31. *How might greater comparability and consistency in product labelling be addressed?*

30. We believe that the 'positive' social and environmental impacts of the investments can be adequately described in the investment strategy section of the KIID. The name of the product will probably indicate that it is trying to reach investors who place high value on these considerations. We think it could be seen as an official endorsement (carrying a degree of unnecessary liability) to grant special labelling to a product

stating that it was socially responsible, green or ethical etc. Sometimes what purports to be environmentally friendly and for the benefit of society is not. Bio-fuels are a recent example, where efforts to produce sustainable energy have had an adverse impact on society through higher food prices. To assist investors in making informed investment decisions concerning environmental and social factors CFA Institute has published '*Environmental, Social, and Governance Factors at Listed Companies - A Manual for Investors'*[1]. Investors need to consider a number of factors when they wish to invest in a way that is sensitive to these issues. Therefore, the value of simply labelling an investment as "ethical" or as "green" is limited and possibly misleading.

31. We do not think this is possible or desirable for the reasons stated above.

4.3 Interaction with and amendments to existing legislation

Questions 32-35:

32. *Should the summary prospectus be replaced by the KIID for PRIPs? Please outline the benefits and disadvantages you see with respect to such an approach.*
33. *Should Solvency II disclosures provided prior to the investment decision be replaced by the KIID for PRIPs? Please outline the benefits and disadvantages you see with respect to such an approach.*
34. *Do you agree with the suggested approach for UCITS KIIDs?*
35. *Are there any disclosures, e.g. required by the existing regimes, which you believe the PRIPs KIID should not include, but which should still be disclosed, e.g. separately to the KIID? Do you have any practical examples for such elements? Do you foresee and difficulties in applying these broad principles to the KIID for all PRIPs, as the building blocks on content and format for a 'level 1' instrument? Please justify or explain your answer.*

32. Yes, we agree the KIID should replace the summary prospectus. The summary prospectus is not a useful document, as it mainly contains legalise and boilerplate for the purpose of protecting the manufacture rather than for the illumination of the investor.

33. No comment.

34. Yes, we agree to the proposed approach, which is not to change the recently adopted level 2 measures for the KIID for UCITS. At this stage, the focus should be on aligning the KIID for PRIPS with the KIID for UCITS. However, we do believe that the KIID will need further refinement.

[1] http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2008.n2.1

35. No comment

4.4 Issues to be addressed by developing appropriate implementing measures

a) Risks

> *<u>Questions 36-37:</u>*
>
> *36. What in your view will be the main challenges that will need to be addressed if a single risk rating approach is to work for all PRIPs?*
>
> *37. Do you consider there are any other techniques that might be used to help retail investors compare risks?*

36. Underlying the seven-box scale of the Single Risk Reward Indicator (SRRI) in the KIID for UCITS are several methodologies designed to suit different types of investment vehicle. In our opinion the presentation of the scale and the underlying methodologies need further refinement; translating the SRRI to PRIPS presents this opportunity. In addition to the risk/reward characteristics found in UCITS, PRIPS contain others such as counterparty and liquidity risks. In the main, we believe these can be measured and added as appropriate to the existing sum of risk factors. We also note that some risks are contingent.

37. As stated above we believe the SRRI needs further refinement in presentation and methodology. We stress that both PRIPS and UCITS must use the same indicator in order to retain comparability between investment products.

b) Costs

> *<u>Questions 38-39:</u>*
>
> *38. What in your view will be the main challenges that will need to be addressed in developing common cost metrics for PRIPs?*
>
> *39. How can retail investors be aided in making 'value for money' comparisons between different PRIPs?*

38. Considering the variety of fee structures, hidden costs, etc., which exist across the broad spectrum of retail investments products; it is a delicate task to present the fees in a concise, comprehensive and comprehensible manner. Conceptually we suggest looking at the product clean of fees and charges, in the case of scenario products calculating the return in the absence of fees. Then calculate the return with fees, subtract the latter from the former to establish the gross charge. The gross charge

can then be expressed in percentage terms and annualised, thereby deriving a comparable cost between products.

39. The Consultation summarises a number of additional non-explicit costs (fees, charges and guarantees) that affect the performance of the PRIP, we believe the basic framework of one-off costs, ongoing costs and contingent costs used in UCITS can be mapped to PRIPS. We believe this can be achieved by accounting for the cash flows as they accrue to the manufacturer and/or distributor and presenting them within the UCITS framework. By retaining the UCITS framework for PRIPS, investors will be able to make direct 'value for money' comparison between these products.

c) Performance

Questions 40-41:

40. Do you consider that performance information should always be included in a KIID?

41. What in your view will be the main challenges that will need to be addressed in ensuring performance information can be compared between different PRIPs?

40. Where available, we believe that past performance should always be included in the KIID. Presented in a standardized and robust manner, past performance can be a useful tool for investors.

41. The main challenge will be to set robust standards of performance measurement. CFA Institute through sponsoring Global Investment Performance Standards (GIPS®)[2] has led the investment industry in comparing composites of performance. The underlying methodologies in GIPS® meet the necessary robustness criteria and could be transferable for both PRIPS and UCITS.

d) Guarantees

Questions 40-41:

42. Do you agree that a consistent approach to the description of guarantees and capital protection in the KIID should be sought, e.g. through detailed implementing measures, for different PRIPs?

43. What information should be provided to retail investors on the cost of guarantees?

[2] http://www.gipsstandards.org/

42. We believe that there should be a harmonized description of downside protection. The word 'guarantee' should be avoided since it is potentially misleading. There is no such thing as a hundred per cent guarantee, some risk will always remain, most notably counterparty risk. This must be clearly disclosed.

43. The *total* cost of the downside protection must be disclosed as an explicit fee, or insurance premium. The disclosure must reference, what is being guaranteed and the name of the guarantor.

31st January 2011.