



To the European Commission and the European Parliament

31 January 2017

Dear Sirs,

PRIPS Regulation - OTC Derivatives

We refer to the Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (**PRIPs Regulation**).¹

We would like to express our support to the policy direction which motivated the PRIPs Regulation. We share your view that the integration of the European retail product market will produce "*choice, transparency and competition in retail financial services to the benefit of the European consumers*", as set out in the Commission's green paper.² A single, harmonised EU-wide Key Information Document (**KID**) will contribute to these objectives.

However, we would like to seize the opportunity, on the occasion of the twelve-month extension to the date of application of the PRIPs Regulation (the new date being set at 1 January 2018)³, to bring to your attention some specific issues to which the drafting of a KID for OTC derivatives gives rise, especially where such derivatives are offered to clients as a risk management tool.

Scope of the PRIPs Regulation

Hedging derivative. In its response of 19 May 2016 to the letter of the Joint Associations Committee, ISDA and ICMA dated 17 February 2016 on some of the outstanding and open questions on the PRIPs Regulation, the European Commission stated that "the PRIPs Regulation does not make any distinctions in relation to the product's intended purpose". The PRIPs Regulation, however, – in its title and across many of its recitals - clearly distinguishes between "investment products", which are in scope of the Regulation and non-investment products, which are not in scope. The latter non-investment products include derivatives which have been entered into by the retail client with a view to hedge risks associated with its activities.

¹ Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIPs), OJ L 352, 9.12.2014, p. 1–23.

² Green Paper on retail financial services - Better products, more choice, and greater opportunities for consumers and businesses, COM(2015) 630 final, 10 December 2015.

³ Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products as regards the date of its application, 9 November 2016, COM (2016) 709 final.



We assume that the European Commission had concerns that a retail client might enter into a hedging product for speculative purposes.⁴ We want to point out, however, that with the entry into force of MiFID II⁵, due to the product governance requirements, an investment firm will have to define, from an early stage, the derivatives that will be distributed for hedging or investment purposes (target market). Consequently, any distributor/manufacturer should be able to provide the KID in accordance with such product governance obligations. If the manufacturer has indicated that a product is only intended for risk management purposes, the distributor should not sell the product for speculative purposes.

Given the wording of the PRIIPS Regulation and due to this new framework, we propose the European Commission to reconsider the application of the PRIIPS Regulation to hedging derivatives, where the target market is limited to retail clients with hedging purposes.

Foreign Exchange Contracts. Additionally, even considering hedging products within the scope of PRIIPS definition, there are still some products where there is no clarity whether they fall under the scope of the Regulation. We refer, for instance, to some physically settled foreign exchange (FX) contracts like foreign exchange forwards, foreign exchange swaps and currency swaps where (i) there is no uncertainty about the commercial outcome of the transaction and where (ii) the investor is acquiring the assets (the foreign currency) directly. These products do not match with the definition of PRIIPS, as included in the final text agreed among the Council, Parliament and Commission, and thus should not be covered by the Regulation.

This clarification is very important due to the great volume of such types of transactions. Additionally, as we argue below, if a specific KID for each currency pair and terms is needed, entities would need to have a great amount of KIDs published.

Generic KID for OTC Derivatives

We understand that it is the European Commission's view that the PRIIPS Regulation applies to OTC derivatives, and hence a KID will be required pre-trade. We foresee, however, a great difficulty, if not impossibility, to have a specific KID completed before each trade.

Generic KID. OTC derivatives are tailor-made, especially those that are entered into for risk management purposes, which makes it difficult to anticipate any potential structure. For instance, where options are concerned, the combination of potential structures is numerous. In general, many terms of an OTC derivative are at the option of the clients and tailored to their very needs, such as, for instance, duration, nominal amount, or the insertion of any floor and/or cap.

Even in case of the more standardize products, potential combinations of alternatives will lead to hundreds of different KIDs for the same "product". As an example, clients may ask for an option with 1

⁴ We understand that the Commission argued, in order to include hedging derivatives in PRIIPS, that manufacturers and distributors may not know what the purpose of the client was when subscribing the derivative agreement.

⁵ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, 12.6.2014, p. 349–496.

year maturity, but also 1 year and 1 week or 1 year, 1 week and 1 day, etc; on a plain vanilla option he may ask for a strike at the money, 1% out of the money, etc. Those alternatives should be covered by the same "generic" KID; if that is not the case, hundreds of KIDs would be needed, and thousands of them considering all potential pair of currencies available in the market.

We are, therefore, of the view that generic KIDs should be allowed. If this would not be the case, retail clients under MiFID would *de facto* be denied access to the broad range of – tailor made – (risk management) products, even in case that are provided under investment advice.

Same PRIIP. Generic KIDs would also contribute to create legal certainty to the industry when identifying if a PRIIPs is "the same PRIIP" in terms of Article 13.4 of the PRIIPs Regulation. This would avoid administrative burdens not only with respect to the distributors, but also with respect to clients who deal frequently in the same OTC derivatives and do not want to slow down the process.

Performance scenarios. To provide figures in accordance with the draft Regulatory Technical Standard (RTS) of 30 June 2016⁶ (the 'draft RTS'), specific data are to be inserted in the formulas. However, in case of OTC derivatives, such data are only known at the time when the trade is entered into, as the time to market is often very short and price sensitive. Hence, it is not possible to provide the client with the completed KID, pre-trade. Moreover, scenarios as currently foreseen in the draft RTS are not adapted to derivatives that, most of the time, do not comprise any investment amount and may have a variable notional (following, for instance, the calendar of the loan) which would lead to inexact figures in the scenarios. We would, therefore, propose to allow performance scenarios in the form of graphs, on the same vein as already permitted for exchange traded derivatives, which only diverge from OTC derivatives by the venue. Moreover, such graphs would provide a client with more detailed understanding on the product than figures do.

From the workshop held on 11 July 2016 by the European Commission, we understand that the Commission agrees to the principle of the generic KID. Until now, this principle is, however, not reflected in the RTS. Furthermore, it remains unclear how generic a KID may be. We would therefore call upon the European Commission to formalize this point of view and provide, with the assistance of the ESAs, and, taking into account the considerations above, further clarification on how to apply a generic KID to OTC derivatives.

⁶ On 30 June 2016 the European Commission adopted a delegated act supplementing the PRIIPs regulation with a provision text, see Commission Delegated Regulation (EU) .../...of 30.6.2016 supplementing Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents Brussels, 30.6.2016, C(2016) 3999 final.

Direct or indirect exposure.

Article 8.3(c)(ii) of the PRIIPs Regulation instructs the manufacturers to include in the section on "What is this product?" a reference to "*whether the objectives are achieved by means of direct or indirect exposure to the underlying investment assets*".

The same instruction is included in the draft RTS (Article 2), but there is no explanation on what is the meaning of the term "direct or indirect exposure".

In order to comply with the PRIIPs Regulation, a clarification in the final version of the draft RTS is needed to allow the manufacturers to classify the products as having direct or indirect exposure to the underlying(s), so that this information is correctly shown in the KIDs.

Revised Template KID

We welcome a template KID and the fact that a standard wording is made compulsory to the market. This will enhance the ability of the retail investors to compare investments products for suitability and value.

However, while the current template KID is well designed for most investment products, it is not the case for derivatives, especially for those that are offered to clients as a risk management tool.

As an example, the expressions such as "*cashing in early*", "*how much you get back*", "*taking out money early*", "*you could lose some or all of your investment*", do not have any relevance in case of an Interest Rate Swap (IRS), irrespectively of whether or not such IRS has been entered into for speculative or risk management purposes, as the client does not invest any money to enter the IRS.

Especially for derivatives entered into for risk management purposes - which is the prevailing case to the extent retail under MiFID clients are concerned -, we believe that the obligatory wording of the template KID (and the way it is to be completed in accordance with the draft RTS) is contra-productive. Instead of better informing a client (as required under MiFID I and MiFID II), those turn out to be more confusing, incomplete and even misleading. In general, the template KID is drafted from the perspective of an investor, seeking return on investment taking into account, among others, its risk appetite; whereas the purpose of an OTC derivative is exactly the opposite, i.e., managing risks.

Consequently, we encourage the European Commission to work with the ESAs in the publication of templates for the KID. In the Discussion Paper dated 17 November 2014, the ESAs included the following question (Q55): "*Do you think that the ESAs should aim to develop one or more overall templates for the KID?*" Since that document, no further news or information has been published in this regard.

We believe it is crucial that the ESAs develop prescribed templates and examples for each different type of PRIIPs, at least for the most common products or the more problematic PRIIPs, such as OTC derivatives. There are many obligations that are still very open or uncertain and may be interpreted in various manners by manufacturers, supervisors and courts. In our opinion, accurate and complete

templates/examples prepared by the ESAs would be the only way to (i) improve the quality and comparability of information provided to retail investors regarding PRIIPs; (ii) improve legal certainty for firms; (iii) achieve a better understanding from the ESAs of the current problems for the manufacturers when elaborating the KID.

Please note that this is the position that some supervisors have taken in connection with other pieces of European regulation (for instance, the issuance of the recent Guidelines on transaction reporting, order record keeping and clock synchronisation under MiFID II⁷ and the related technical documents on reporting instructions, as published by ESMA), with positive feedback by the industry.

Alternatively, we would suggest allowing manufacturers to draft KIDs, which take into account the typical features of a risk management product, including reference to the underlying risk, thus rendering the KIDs consistent with the information provided in accordance with MiFID.

PRIIPs Already Available on the Market.

A clarification would be needed regarding PRIIPs issued before the entry into force of the PRIIPs Regulation and those that are still available to retail clients in different trading platforms after the entry into force of the Regulation. In practice, some manufacturers may not make and publish on their websites the relevant KID, which may imply, in practice, limiting the range of products available to retail clients. This is especially important when the manufacturers of such PRIIPs and/or the market where they are listed are not located in the EU.

In those cases, a distinction should be made between clients who are offered with such products and clients who try to acquire them on their own initiative. Whilst in the first case distributors should refrain to offer the product if there is no KID available, in the second case, the product is being sold under an execution basis. In these second cases, firms should not limit clients' intention to purchase the product, but only warn them of the non-availability of the KID before they trade.

If that is not the case and distributors must limit clients' trading intention, those clients would have two main alternatives with respect to the certain PRIIP (i.e., a future or option issued by a US market): (i) refrain from purchasing the product, even when the client is fully aware of all the product risks and may have traded hundreds of times prior the entry into force of the PRIIPs Regulation; or (ii) use a third country distributor (i.e., US execution website) to acquire the PRIIP.

Whilst we understand that point (i) is not the objective that the PRIIPs Regulation tries to achieve, point (ii) would be even worse, as the European client will lose all other protections arising from European legislations (i.e.: MiFID) and, additionally, there would be a disadvantage for all European intermediaries in favour of third country firms who are not supervised by European entities.

⁷ 10 October 2016 | ESMA/2016/1452.

In the past, concerns similar to the above have been raised by other institutions. Those have finally resulted in the letter of Lord Hill of 19 May 2016 announcing additional guidance from the ESAs. Now that the final version of the draft RTS should be approved soon, it would be recommendable for the sake of legal certainty that these doubts are addressed not in a Q&A, Guideline or any similar non-binding document from the ESAs, but in such RTS itself, which has binding effects and is subject to the control of the Commission, Council and Parliament.

We would like to call on you to amend the draft RTS, taking into account the considerations above, in the interest of both the sector as well as its clients. Notably, we would ask for the following:

- To confirm that derivatives offered for risk management are out of scope;
- To confirm that in any event FX forwards and FX swaps are out of scope;
- To amend the draft RTS so as the final adopted version of the RTS contains a definition of the term "direct or indirect exposure";
- To clarify the treatment of PRIIPs issued before the entry force of the PRIIPs Regulation already available on the market;
- To propose that ESAs develop templates and examples for each type of PRIIPs, at least for the most common products or the more problematic PRIIPs, such as OTC derivatives. Alternatively, to allowing manufacturers to draft generic KIDs, taking into account the typical features of a risk management product (if these types of products should be in scope), thus rendering the KIDs consistent with the information provided in accordance with MiFID.

Yours faithfully,



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The Vice-Chair