ROPES & GRAY

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New disclosure requirements applying to EU fund distribution in 2018

Attorneys
John Young
Kirsten Lapham

Asset managers located inside and outside the European Union ("**EU**") must comply with the new "point of sale" disclosure requirements that will apply when they distribute financial products, and investment services, to EU investors and clients.

These requirements derive from the next iteration of the Markets in Financial Instruments Directive ("**MiFID II**") (applying on 3 January 2018), and the EU Packaged Retail Investment and Insurance Products Regulation (applying on 31 December 2017) (the "**PRIIPs Regulation**").

This Alert provides an overview of the impact on the new requirements that relate to fund distribution in the EU. The precise application of the rules will depend on the types of funds distributed in the EU, the distribution channels used, and the types of investors targeted.

Firms subject to the requirements – encompassing many firms that distribute investment products in the EU – must consider the form of the disclosures that they are required to make and the data required. In particular, firms may need to obtain a large amount of data on existing funds (in relation to, for instance, funds' transaction costs incurred to date) in order to produce the disclosures, and should consider starting this data-gathering exercise well in advance of the application date of the new requirements.

MiFID II

MiFID II requires an EU "investment firm" (which is an EU firm regulated by MiFID) to provide appropriate information to clients in relation to a financial product (including any fund) that is recommended or marketed to a client of the firm. There are requirements on the manner in which information on past and predicted future performance is presented, and various prescribed items of information to be provided about the firm and the service, including risks. The firm must also disclose all costs and related charges relating to the investment, to allow the client to understand the overall cost as well as the cumulative effect on return of the investment, with an itemised breakdown of these costs and charges. The costs and charges that must be disclosed include any "one-off" fees paid to the supplier of the product on initial investment, ongoing management and performance fees and all transaction costs. In a fund context, the distributor must disclose costs such as broker commissions paid by the fund in relation to its underlying transactions, related transaction taxes and foreign exchange costs. Transaction costs also include the interest costs of the fund's borrowings and the cost of research, if borne by the fund or client. The amount of performance fees, if any, will also need to be estimated. In practice, the amount of transaction costs and performance fees will depend upon future management activities and cannot be ascertained up front. A firm will need to use actually incurred costs as a proxy for expected costs, or make a reasonable estimate of these costs. Unlike under the PRIIPs Regulation (see below), MiFID II does not prescribe a particular methodology for calculating these costs, or a template disclosure.

All these types of costs will need to be aggregated and presented to the investor both as a percentage and as a cash amount (based on a standard investment in a fund of, say, EUR 1,000). The firm will also need to provide an illustration (such as a graph) that shows the cumulative effect of costs on return over an average holding period.

As well as providing this information at point-of-sale, where a firm has an "ongoing relationship with the client", the firm must provide ongoing information on costs on at least an annual basis during the life of the investment, based on actual costs incurred and on a personalized basis.

The information must be provided "in good time" where the firm recommends or markets financial instruments to clients, or where a firm providing any investment service under MiFID is required to provide clients with a UCITS key investor information document ("**KIID**") or PRIIPs key information document ("**KID**").

In practice, the obligation will apply where an asset manager (within or outside the EU) appoints an intermediary in the EU to distribute a fund, on the basis that the distributor will be conducting its distribution activities under a MiFID authorization and subject to MiFID rules. The obligation may also apply where an asset manager distributes its own products in the EU under a MiFID authorisation.

PRIIPs Regulation

The PRIIPs Regulation applies to the distribution of any fund to a retail investor in the EU, regardless of whether the distributor (or manager, referred to in the Regulation as the "manufacturer") is in the EU. It does not apply to distribution to professional investors.

A manufacturer or distributor of a fund must draw up and make available a pre-contract disclosure document (a "key information document" or "KID") before making the fund available to a retail investor in the EU. The KID must be concise and no longer than 3 pages of A4 and follow a prescribed format. It contains a summary of the product and investment objectives, the type of investor to whom the fund is marketed, various modelled future performance scenarios, estimates of total costs (including underlying transaction costs) and the effect of costs on performance. It also includes a "comprehension alert" (where applicable, for "complex" products), a summary risk indicator, reference to liquidity risks (if relevant) and a description of the fund's risk and reward profile. The summary risk indicator is based on an assessment of the fund's market risk and credit risk (if any). The PRIIPs Regulation includes methodologies for determining the product's market risk and credit risk, and estimating future performance. As it presents this information in a strict format, the KID will allow a retail investor to make like-for-like comparisons across a range of products when making an investment decision.

Similar to MiFID II, the KID also includes costs disclosure, encompassing both directly incurred costs such as management fees and performance fees, as well as transaction costs. The requirement to model a fund's future transaction costs will involve considerable work. The rules require an estimate of future transaction costs based on an average of the transaction costs incurred by the fund over the prior three years. Transaction costs must also take account of the difference between the price of the instrument at the time a sale or purchase order is transmitted to a broker for execution (the "arrival price") and the net realized execution price, including all commissions and taxes. The Regulation includes a methodology for applying this to derivative positions (OTC and exchange traded) and foreign exchange, and to illiquid assets. For new products, transaction costs are calculated based on an estimate of the portfolio turnover in each asset class, using a methodology based on reference indices.

The product manufacturer must keep the information in the KID under regular review and update it at least annually, by reference to, for instance, new market data or changes in investment strategy.

UCITS managers are under an existing obligation to provide a UCITS key investor information document (KIID) as pre-sale disclosure. UCITS managers are exempt from the obligation to produce a PRIIPS KID until 31 December 2019.

Other than for UCITS funds, there is no grand fathering for existing products or existing fund raisings. However, where a product is no longer made available to retail investors and there is no subsequent change to the product's terms and conditions, a KID is not required.

A manufacturer or distributor could incur liability for a misleading KID, either to an investor (which will largely be a matter of local law) or to an EU competent authority.

Whilst the PRIIPs rules primarily effect the provision of alternative investment funds, structured securities and deposits and derivatives with a retail focus in the EU, asset managers within and outside the EU should be wary of the incidental impact of the rules where a fund is sold to one or a small number of retail investors.

Overlaps between MiFID II and PRIIPs

Both MiFID II and PRIIPs require a firm to calculate and disclose underlying transaction costs. PRIIPs sets out a detailed methodology for this exercise, including, for instance, the treatment of fund anti-dilution mechanisms, the approach to estimating transaction costs for new funds and the approach for calculating transactions costs for funds (such as feeder funds or funds of funds) that invest in other funds. MiFID II does not set out any particular methodology.

Whilst PRIIPs excludes UCITS from its scope, the requirements in MiFID II will apply to UCITS funds. This will require UCITS distributors (governed by MiFID in the EU) to obtain information on costs (including transaction costs) from the UCITS manager.

EU asset manager industry associations have worked with the industry to come up with various methods for a complete disclosure which addresses MiFID II and PRIIPs, although firms will need to consider their own approach, based on their products, target investors and distribution channels.