



OPINION OF SMSG

SMSG Opinion Paper on PRIIPs Regulation – Performance Measures

Executive summary

In this opinion paper, the SMSG presents its grave concern that the key information documents (KIDs) made subject to the PRIIPs Regulation will not include historical data, which is a source of relevant information for retail investors that is objective, comprehensible and usefully complements other indicators. It is the opinion of the SMSG, and shared by its consumer and industry representatives alike, that to exclude historical data from the presentation of risks and rewards will be seriously detrimental to retail investors and their possibility of understanding and comparing PRIIPs and would represent an unwarranted step backwards in investor protection. The paper opens with a comment on the role of the SMSG and why it responds to an issue that concerns the interpretation of a level 1-legislative text.

I. The Role of the SMSG

1. The new European System of Financial Supervision (ESFS) that was established after the Financial Crisis has transferred considerable powers of financial regulation and supervision to supranational authorities, not just the bodies established by the Treaties such as the European Parliament, the Council, and the European Commission but also the new European Supervisory Authorities (ESAs). It is vital both to ensure effective regulation and to maintain legitimacy and public confidence in the ESFS that these authorities and their use of powers are subject to public transparency and that they remain accountable to the public.
2. Following the reform of the founding treaties, legislation on level 1 according to Article 289 of the Treaty on the Functioning of the European Union (TFEU) by the EU legislators can be supplemented by rule-making on level 2 according to Articles 290 – 291 TFEU by the European Commission that may be assisted in this task by drafts provided by one or more ESAs.
3. One such ESA is the European Securities and Markets Authority (ESMA) established according to the European Parliament and Council Regulation 1095/2010. To ensure transparency and accountability where rules are made on level 2, the Regulation calls on ESMA to »consult interested parties on regulatory or implementing technical standards, guidelines and recommendations and provide them with a reasonable opportunity to comment on proposed measures«, cf. consideration 48.

4. At the same time, the Securities and Markets Stakeholder Group (SMSG) was established according to Art. 37 of the ESMA Regulation to ensure that this commitment to consultation is made more »efficient«, cf. the said consideration. Whereas consultation with the public at large cannot by practical necessity involve deeper engagement, the establishment of a body comprising a balanced proportion of » financial market participants, small and medium-sized enterprises (SMEs), academics and consumers and other retail users of financial services« ensures a more efficient engagement with stakeholders and is thus instrumental in providing the necessary transparency and accountability. The other ESAs were provided with their own stakeholder groups for the same reason, EIOPA having two such groups to reflect its binary scope of both insurance and occupational pensions.
5. Thus, the role intended by the EU legislators for the SMSG was to ensure public transparency and accountability by offering its opinions and advice to ESMA. The papers produced by the SMSG are made publicly available at the homepage of ESMA as are the minutes of its meetings, thereby providing valuable insight for the public and assurance that stakeholder involvement is observed.
6. As ESMA is primarily engaged with drafting technical standards as level 2-instruments and promoting supervisory convergence among national competent authorities (NCAs), the role of the SMSG is to provide its opinion on these matters, cf. Article 37(5). It does not follow that the SMSG can only act in response to a consultation from ESMA and the SMSG has on several occasions provided ESMA with its opinions on various matters that are deemed important by its members, often anticipating later legislative initiatives. Also, the SMSG is expressly expected to warn ESMA of any breaches of EU law, including level 1 legislation, that comes to its attention, cf. Article 17(2) of the ESMA Regulation.
7. This opinion paper is such a unilateral initiative by the SMSG. It concerns the proper understanding of a particular statutory provision on level 1. Normally, the SMSG would not address such an issue, because level 1 legislation is outside its scope as intended by the EU legislator. In this particular case, however, the issue at hand is the interpretation of the level 1 text as part of the level 2 rule-making which directly involves ESMA and thereby the SMSG. To be precise: the relevant question is whether a certain understanding can be expressed in the mandated level 2-instruments, when that understanding is not mentioned in the level 1-text. The absence of a clear level 1-text in this respect makes the issue at hand a question of the proper design of the level 2-instruments and as such the SMSG sees itself entitled to express its opinion to the public and to the authorities involved in EU law-making.

II. The Problem at hand

8. The European Parliament and the Council Regulation 1286/2014 mandates key information documents (KIDs) for packaged retail and insurance-based investment products (PRIIPs). The SMSG consider the PRIIPs Regulation a very important and helpful step in promoting investor protection. PRIIPs can be difficult to understand for retail investors, but also offer financial benefits that should not be denied them. Consequently, it is imperative that retail investors are offered the necessary information to assist them in making an informed and suitable choice and the mandatory use of KIDs will help in this effort.
9. The PRIIPs Regulation clearly and explicitly describes the purpose of the KIDs. From the preamble of the Regulation, it should be noted that:

10. »To meet the needs of retail investors, it is necessary to ensure that information on PRIIPs is **accurate, fair, clear and not misleading** for those retail investors. This Regulation should therefore lay down common standards for the drafting of the key information document, in order to ensure that **it is comprehensible to retail investors**. Given the difficulties many retail investors have in understanding specialist financial terminology, particular attention should be paid to the vocabulary and style of writing used in the document. Rules should also be laid down on the language in which the key information document should be drawn up. Furthermore, retail investors should be able to understand the key information document on its own without referring to other non-marketing information«. (cons. 13)
11. »Retail investors should be provided with **the information necessary for them to make an informed investment decision and compare different PRIIPs**, but unless the information is short and concise there is a risk that they will not use it. The key information document should therefore only contain key information, in particular as regards the nature and features of the product, including whether **it is possible to lose capital, the costs and risk profile of the product, as well as relevant performance information, and certain other specific information** which may be necessary for understanding the features of individual types of product«. (cons. 15)
12. It is evident that the EU legislator wanted KIDs to be comprehensible for retail investors and yet provide them with reliable information. The retail investor's expectations are aptly described by the mandatory introduction to a KID set out in Article 8(2):
13. 'This document provides you with key information about this investment product. It is not marketing material. The information is required by law **to help you understand the nature, risks, costs, potential gains and losses of this product and to help you compare it with other products.**'
14. Article 8(3) describes the mandatory content of KIDs and Article 8(5) empowers the European Commission to adopt regulatory technical standards (RTSs) based on drafts provided by the three ESAs through their Joint Committee to provide more detail.
15. The ESAs published a Discussion Paper on 17 November 2014 as part of their obligation to consult the public before adopting the draft level 2-instruments that they will present to the European Commission. On 17 February 2015, the SMSG published its response (ESMA/2015/SMSG/005) to the Discussion Paper. In part IV of its response on the presentation of risks and rewards, the SMSG observed that historical data on past performance was not included in the measures suggested by the ESAs in regard to »(b) the methodology underpinning the presentation of risks and rewards as referred to in points (d) (i) and (ii) of paragraph 3«, cf. Article 8(5) of the PRIIPs Regulation.
16. The SMSG expressed its concern over this absence and expressed the wish that this kind of information should be integrated in the presentation of risks and rewards. However, the SMSG has learned that the ESAs are under the impression that the absence of a direct reference to historical data on past performance prevents the desired inclusion in the KIDs. This conclusion is understandable, because a specific reference was made in the European Commission's proposal, COM(2012) 352/3, where Article 8(2)(g) concerned the issue »How has it done in the past«, and was later removed under the negotiations that lead to the proposal's adoption.

17. While the SMSG naturally accepts the ESAs respect of the legislative intent on level 1 and the need for all European authorities to stay well within a clear legal mandate, the SMSG was and is not convinced that the intent of the EU-legislators was to deprive retail investors entirely of this source of relevant information. Rather, the change of the proposal may have been made to remove the emphasis on past performance, which could be inductive to misleading overreliance, and introduce a broader scope of relevant information including various forward-looking scenarios. The removal of the specific reference to past performance appears to be made in the European Parliament's report of 6 November 2013. However, the amendment is justified in the explanatory statement simply: »Indicative future performance scenarios based on a multifactor analysis (e.g. counterparty risks) will be preferable to risk indicator based on the track record of past performance. However, the retail investor should be aware that any other risk may not be reflected in this performance scenario«. Thus, the adopted wording of Article 8 does not explicitly rule out the use of historical data, as it only suggests that a multifactor analysis would be preferable to reliance strictly on past performance.
18. We do not, as an SMSG, express a definitive view on the legal text of Article 8(3) as this is the prerogative of the Court of Justice of the European Union. But we regret that the current mandate is, at least, ambiguous with respect to the possibility of past performance information being included in level 2 instruments and that, by implication, it has led to an interpretation of the mandate which excludes past performance data being included.
19. For this reason and since the exclusion of such information in the KIDs is considered seriously detrimental to investor protection by the whole SMSG, including consumer interests and industry, the SMSG alerted the relevant EU institutions, notably the European Parliament and the Council, of this problem by a letter dated 13 October 2015, where we called for this matter to be revisited.
20. As the letter remains unanswered, the SMSG as a body representing stakeholder interests sees no other alternative than to issue this opinion paper, where we set out in detail the reasons for our grave concern.

III. Our concern

21. It follows from Article 8(3) that KIDs must provide in a comprehensible manner a presentation of the risks and rewards connected with investment in a PRIIP. This can be done in many ways, and the SMSG is generally favourable of the parameters contemplated by the ESAs. However, these parameters are all based on forward looking data, that is, the expectations of the producer of the PRIIP. Our concern is that without the inclusion of historical data on past performance, either the factual past performance, where the PRIIP has such a record, or the constructed past performance, where the PRIIP is yet without a record, these parameters will be of little value to retail investors and would fail the intent of the EU-legislator to provide them with the »accurate, fair and clear« information that they would expect from a KID and impairing their ability to »understand the nature, risks, costs, potential gains and losses of this product and ... compare it with other products« as promised them in Article 8(2).
22. It is irrefutable, that historical data on past performance is no certain guidance on future events, but neither are the expectations that form part of the proposed forward-looking parameters. In that respect a comparison of historical data with forward-looking data falls clearly to the advantage of the former, because historical data is objective and testable. Historical data offers a clear test for any PRIIP, because it is readily available and provides a more comprehensible guide to retail investors than other forward-looking indicators that usually depend on certain choices and estimations made

by the producer of the PRIIP. Historical data, on the other hand, is less susceptible to manipulation or distortion. Whereas the future may hold many different outcomes for the producer of a PRIIP to choose among in setting various scenarios based on complicated conditions, historical data consists of settled facts and the structure of the PRIIP offers the only relevant scenario to apply. For any given PRIIP, the future may hold many different outcomes, but history provides only one. Furthermore, by offering only one scenario, that of its past performance based on historical data, it becomes easier for retail investors to compare different PRIIPs, which is one of the key purposes in making KIDs available. Although neither is a certain guide, to ask how the PRIIP will perform depending on the many possible scenarios that can be envisaged is obviously less comprehensible for a retail investor than asking how did the PRIIP perform or would have performed and then compare it to other similar products. The SMSG agrees that past performance should not be the single indicator of risks and rewards, as was originally proposed by the European Commission, but it should be integrated with other relevant multi-factor parameters to provide the retail investor with a clear picture.

23. It is noteworthy, that the wish to apply historical data as an integral part of the presentation of risks and rewards is shared within the SMSG among both consumer interests and industry. The European Commission also appreciate the importance of historical data as a tool to understand and assess financial products as evidenced by its Capital Markets Action Plan released only recently on 30 September 2015, which requires the ESAs to analyse the actual performance of retail investment products.
24. It is a further concern to the SMSG, that if historical data is excluded in this way from the presentation of risks and rewards in KIDs subject to the PRIIPs Regulation, not only will the on-going effort by both ESAs and NCAs to collect and make available historical data be impaired, but there is a risk that historical data will also be removed from similar presentations made subject to the EU-legislation on UCITS.
25. Considering that historical data is most often included in the presentations made by producers of PRIIPs today and that it is mandated as part of the investor protection offered by the regime applicable to UCITS (the KIID regime), this would constitute a severe step back in the protection of retail investors contrary to the legislative intent behind these important instruments of EU law.
26. The SMSG therefore restates its concern in the hope that the EU-legislators, the European Parliament and the Council respectively, will revisit this issue and make it clear that it was not the intention to deprive retail investors of the easily understandable source of relevant information that makes up historical data on past performance and that there are no other bounds on the interpretation and application of Article 8(3) than what follows from its wording and from the need to pursue its purpose of providing retail investors with comprehensible information about PRIIPs that will enable them to understand and compare these products.

This opinion will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 3 February 2016

A handwritten signature in blue ink, consisting of several overlapping loops and a final horizontal stroke with a small upward tick at the end.

Jesper Lau Hansen
Chair
Securities and Markets Stakeholder Group