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**KEY INFORMATION DOCUMENT, A NEW TOOL TO PROTECT  
INVESTORS**

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*Ai sacrifici della mia Famiglia.*



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## INTRODUCTION

The latest Directives implemented in the European Union, concerning financial market and financial instrument, operated important changes in financial market's structure, especially in the field of transparency and protection of retail investors. The objective of this dissertation is to analyze the Key Information Document and the way in which it changes and improves the protection of the retail investors. This tool renovates the disclosure process using an alternative approach with respect to the previous form of transparency implemented by the legislator. The main news introduced by this tool is the centrality of risk of investment regarding the description of the product's characteristics. The information presented in Key Information Document have a numerical nature, which renovates the disclosure process from the summarization and visualization viewpoints.

The themes of investor's protection and the transparency result relevant since the retailers play a fundamental role in the financial market, and without an adequate protection the financial industry runs the risk to lose an important share of clients. The loss of faith in the financial system after the global financial crisis undermines the efficacy of rules settled in Market in Financial Instrument Directive (MIFID). Thus, the legislator operated further upgrades with MIFID II, designing an investor's protection with the aim of gaining back the faith of retail investors, lost during the financial crisis. The relation between advisor and retail client is influenced by an asymmetric information which makes interesting the way in which the legislator manages this delicate situation. Nowadays, the investor's protection is a recurrent problem in the financial market and it is important understand and analyze in which way the retail client is protected in the relation with the investment advisor.

In this dissertation we analyze the Directives and the Regulations which design European financial market, taking in consideration the period from the introduction of MIFID to the January 2018, data of entry in force of Key Information Document. The analysis compares the old transparency's tools with respect to the KID. The comparison investigates the different methodology used by the tools and the motivation which obliges the legislator to design a new tool. Being the KID an instrument introduced less than one year ago it has not been possible to operate an empirical research on market data to assess the validity of the information reported. By the way, the analysis revealed important changes into the legal framework that a retail investor needs to know before pursuing an investment in packaged retail insurance-based investment product.

The remainder of the dissertation is organized as follow. The first chapter describes initially the European financial market highlighting the necessity of a common European regulation and the relevance of relation between investor and financial advisor. Thus, the chapter shows how the European legislator regulates the protection of investor before the crisis with MIFID and after the crisis through MIFID II and MIFIR, paying particular attention over the consequences of the crisis over the new rules of financial transparency. The second chapter analyzes the products for which is mandatory the use of KID. These products are known as packaged retail insurance-based investment products (PRIIPs). The description shows different categories of PRIIPs, but the central topic is the complexity of the products and the consequent implications for the retail investors. Chapter three analyzes the Key Information Document, the analysis is focused on the Risk and Return of the product; anyway, all the aspects are well described which concern the form and the content of KID. The last chapter concludes the dissertation outlining the transparency paradox and the way in which the legislator overcome it with the introduction of KID, taking in consideration the centrality of risk and the numerical information. The fourth chapter points out also the aspects that should be improved in the future by the legislator to guarantee the effectiveness of the new framework of client's protection.

# 1. An Overview on European Financial Market and on the Importance of Retail Investors

## 1.1. Necessity of a Common Regulation for EU Financial Market

The concept of financial market involves any market in which occurs an exchange of securities<sup>1</sup> between agents. Essentially it is a multilateral system in which multiple third-party are able to interact with the system, buying and selling trading interest in financial instrument<sup>2</sup>. Securities assume the role of supporting tools for the trading interest of agents. There are two main ways to participate in this market: provide investment or financing opportunities, through the purchase or the issue of securities. There are three different types of activity in the market: pre-trading activity, trading activity matching interest and post trading activity. Financial market is the system which allows to agents to distribute wealth between them and across the time horizon.

Different markets have different characteristics depending on the agents that operate in the exchange, types of securities traded and rules it is been operating under. This short definition let us understand that financial market, intended as the world financial market, is a well-defined complex system<sup>3</sup>. The complexity is an aspect that characterized the market in general, given the double nature of exchange regulation, that is composed by a financial side, more related to economical aspect, and by a juridical side. The degree of complexity increases in an exponential way taking in consideration the dynamism of financial market. The dynamic nature of phenomena is influenced by several different factors that contributed to revolutionize the market, in particular in the last years. The mention of some macro-factor helps to identify in a practical way the problem that agents have to face.

In last years, technology contributes to develop a financial market more efficient and integrated. On the other side as usually happened, the speed at which the technology improves is higher than the capacity of legislators, across the world, to regulate new scenario. The lack of regulation in the market allows to agents to take advantage of arbitrage opportunities existing in the market. It happened with the globalization of market, the creation of interdependence of national economies across the world and consequent cross border situations easy to exploit for

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<sup>1</sup> Security: include stocks, treasury stocks, bonds, debentures, certificates of interest or participation in profit-sharing agreements, collateral-trust certificates, preorganization certificates or subscriptions, transferable shares, investment contracts, voting-trust certificates, certificates of deposit for a security, and a fractional undivided interest in gas, oil, or other mineral rights. By Legal Dictionary, FARLEX

<sup>2</sup> Art 4 Directive 2014/65/EU

<sup>3</sup>R.N. MANTEGNA, *Hierarchical structure in financial markets*, The European Physical Journal B,1999

speculators. Nowadays technology go further and the developing of financial engineering allows to investors to use new techniques and strategies of investment, that stimulate the creation of more sophisticated products offered to the clients. This process in which legislators are chasing technology, even if necessary, contributes to overcomplicate the financial market. An important factor to take into account is the turnaround of traditional balance of power between financial and industrial factors in the investment sector<sup>4</sup> that increase the power and the importance of financial market. Geopolitical situation is an element to consider since diplomatic ties between main world powers can change the financial scenario in a while with direct consequences in the world financial market. The complexity of the market, determined by a tremendous number of dynamic factors and interlinked between them, let to legislators around the world tough issues to solve.

The European Union is an interesting case to analyze because started to simplify the complexity of financial market to improve the efficiency and thus the economic condition of people. The first step to reduce the complexity of the European financial market was the constitution of European Monetary Union (EMU) in January 1<sup>st</sup> 1999, even if the effective circulation of the currency started in January 1<sup>st</sup> 2002. Euro reduced the number of currency from eleven to one in the first moment and today it is used in nineteen countries paving the way for a less complex Economy and so a more uniform market.

The discrepancies in the regulation of various functions of EU financial markets in national law did not allow issuers, financial institution and investors to reap the full benefits<sup>5</sup> of a EMU. The will of European Legislator was clear since the Financial Service Action Plan (FSAP) in 1999<sup>6</sup>. The plan contains a framework to uniform three strategic objectives in the European Union:

- Wholesale Markets
- Retail Markets
- Strengthening Prudential Structures

This plan was settled to solve some discrepancies in the market, in fact was already possible for a financial institution offer service in the whole union, but a range of legal and administrative problems have hampered cross border transactions of these financial services. Action Plan had not a direct effect over the European Laws. However, it draws up a list of objectives to reach, and let us understand the will of European Council to constitute a common regulated European

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<sup>4</sup> F. Di CIOMMO, *Investment advisory under MIFID 2: legal issues*, Rivista Trimestrale di Diritto dell'Economia, 2017

<sup>5</sup>E AVGOULEAS, *The Harmonization of rules of conduct in EU Financial Markets: Economic analysis, subsidiarity and investor protection*, European Law Journal, 2000

<sup>6</sup> [www.eur.lex.europa.eu/legal-content/](http://www.eur.lex.europa.eu/legal-content/), will of legislator contained in section summary of the FSAP

financial market. Furthermore, EU regulator has chosen to replace national regulators with a more effective alternative also to facilitate the establishment process of EU regulator. The purpose of harmonization process of the financial market is oriented to reduce the complexity and obtain important upgrades such as: the reduction of compliance cost for intermediaries of cross border investment, the elevation of legal certainty and the rise of competition across different countries that will increase the efficiency of the market. This development, has the potential to lead to a serious weakening of the bargaining power of national regulators and so affects the quality of national protection rules and their enforcement<sup>7</sup>. In fact, without a European regulator there were the possible risk that national regulators were influenced by incentives of financial institutions, starting a race to reduce investor protection. The harmonization could have a twofold effect on the union, improving the previous rules and at the same time it coordinates the legislation of different Member State.

### **1.1.1. Relevance of Investors and Financial Advisory**

The agents in financial market are distinguished according to their role, needs, preferences and behavior<sup>8</sup>. Mainly the roles played by market agents can be summarized in: Investors, Securities' Issuers and Intermediaries. These roles are not fixed or exclusive for the agents and a single subject can perform different functions.

The investor is an individual or a legal entity who commits money to investment products with the expectation of a financial return<sup>9</sup>, the gain is not free for the investor, but he has to take the risk to suffer a loss. In a structured financial market, investors provide important resources to the economy and at the same time protect and enhance their wealth. Investors are an important source of funds for the market, and it, in order to raise the highest quantity of money, offers to investor a huge quantity of investment options. Supply of financial market usually satisfies all investors' requirement, but on the other side the risk of market's failure to guarantee the perfect match between supply and demand is unavoidable. The awareness of parts plays an important role in the efficient allocation of securities; weak competence and knowledge derived by a poor quantity or quality of information can mislead the investor in the process of choosing the option that best suits them, bringing to an inefficient allocation of resources. Unfortunately, mis-selling episodes are usual in financial market and often legislator has to intervene especially in a market

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<sup>7</sup> E AVGOULEAS, *The Harmonization of rules of conduct in EU Financial Markets: Economic analysis, subsidiarity and investor protection*, European Law Journal, 2000

<sup>8</sup> *Overview of Financial Markets and Instruments*, Pietro Millosovich.

<sup>9</sup> <http://www.investorwords.com>, Investor Word Glossary

such as EU, which is, as aforementioned, in a consolidated and harmonized process. The main risk for the market is to lose an important amount of resources that could help to consolidate and reinforce the economy. From this perspective EU cannot incentive the investments in the market without a dedicated regulation regarding investors' protection<sup>10</sup>. Investor's protection is one of the main arguments that the EU Legislator had considered to improve and create a more efficient and transparent market.

Another activity strictly linked to investor is financial advisory, that is a function carried out by intermediaries. This player has an important role in the efficient allocation of resource because it is the reference point for retail investor with weak competence and should give recommendation in order to satisfy the specific needs of the investor. It is not rare that an intermediary performs more types of activities at the same time, and so it could be exposed to conflict of interest situation. The conflict concerns the advisors that get paid or receive some benefit to sell in the market a specific product. The incentives to deviate for the financial advisor can bring to an unsuitable investment for the investors, especially if its financial education is inadequate. This phenomenon is present in the whole market and to contrast it Member States during the years had to formulate different legislations to regulate financial advisory, EU saw this element as crucial for the restructuration of the European financial market since it is not only an element to harmonize but a crucial point for the effective improvement of investor's protection in Europe.

This analysis highlights how much is important the role of the investor as resource, and on the other side the threats at which it is exposed in the complexity of financial market. In this kind of scenario, the EU regulator has the hard role to implement a harmonized framework, with the aim to improve the market efficiency. It shall pursue his objective taking in account that 'the implementation of directives in national law has the disadvantage that the search for applicable national provisions based on European law is usually made very difficult'<sup>11</sup>.

## 1.2. Historical Evolution of European Financial Markets

After Investment Service Directive (ISD)<sup>12</sup> EU financial market was object of further regulation, in fact in 1999 EU Commission designed a Financial Service Action Plan (FSAP) in which are settled main strategical objectives to achieve a common regulation. Action Plan

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<sup>10</sup> G. S. WILLEMAERS, *Client protection on European financial markets – from inform your client to know your product and beyond: an assessment of the PRIIPs Regulation, MiFIDII/MiFIR and IMD 21*, SSRN

<sup>11</sup> T MJ MOLLERS *Capital Markets Law in Europe. Too Many Rules. Too Quick and Complicated?*, ISSN, 2016

<sup>12</sup> Directive 93/22/CEE



was focused on integration of market (Wholesale market), the security of financial services in the market (Retail Market), the strengthen of supervisory and prudential rules. The achievement of the aims was planned through the issuing of 42 different measures such as Directives, Regulations and Guidelines; within 2005. In addition, were created also the Committee of European Securities Regulators<sup>13</sup>(CESR), with the aim to advise the Commission and to coordinate the EU legislation in Member States; and the European Securities Committee<sup>14</sup> (ESC) composed by representatives of Member States, with the purpose to advise the commission about technical regulation of market and financial services.

The most effective tools, that EU Commission has to implement the EU Financial Market, are Directives and Regulation. The European Union defines Directive as a legislative act that sets out goals that all EU countries must achieve<sup>15</sup>. The Directive is more than an order but let to the Member States some degree of discretion about the way in which national authorities have to implement it. The goal must be achieved by Member States within a deadline and are imposed penalties otherwise. The advantage of Directives is the perfect suitability between goal and the respect of national peculiarities across the Union. The Regulation on the other side is a binding legislative act and it must be applied in its entirety across the EU<sup>16</sup>, this approach is more direct than Directive's one because allow to the legislator to applicate the same rules in the whole EU, without the filter of the national legislations. Regulations are more rigid, anyway it gives the possibility to EU legislator to reach a very precise objective since must be observed by EU citizen like a law. The EU Council shall use properly these forms of law to achieve the goals in the better way possible looking at the sensitive equilibrium between harmonization of the Union and National identity.

After the Action Plan, EU legislator started to regulate financial market with some important Directives, in the field of transparency an important goal was achieved with the introduction of Prospectus, through Directive 2003/71/EC. "The Prospectus shall contain all information which, according to the particular nature of issuer and securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities"<sup>17</sup>. It is clear that Prospectus is a disclosure document that is mandatory for determine categories of securities,

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<sup>13</sup> Decision of EU Commission n 527/2001/CE

<sup>14</sup> Decision of EU Commission n 527/2001/CE

<sup>15</sup> [https://europa.eu/european-union/eu-law/legal-acts\\_en#directives](https://europa.eu/european-union/eu-law/legal-acts_en#directives)

<sup>16</sup> [https://europa.eu/european-union/eu-law/legal-acts\\_en#directives](https://europa.eu/european-union/eu-law/legal-acts_en#directives)

<sup>17</sup> Art.5, Directive 2003/71/EC

designed to ensure a better investment's assessment. This can be considered the first tangible step of EU regulator aimed to protect the rights of investor since it gives useful additional information to investors and at the same time constitute a passport for primary market activity. Prospectus is going to be analyzed in a deeply way in the following sub-chapter<sup>18</sup>.

### 1.2.1. Financial Advisory in MIFID I

Investment advisory was mentioned in ISD which highlight the key role of client, defining investment recommendation as an activity that shall be made in the best interest of the client<sup>19</sup>. By the way, only with the adoption of Market in Financial Instruments Directive<sup>20</sup> (MIFID) these duties about advisory activity acquired statutory force. MIFID replaced ISD since the last one wasn't effective in the building of a solid legal framework. ISD tried consolidate the market with a minimum harmonization, while MIFID's approach is deeper and direct to harmonize the market with the goal to ensure investor's protection and uniform competition. The failure of ISD was also due to the dynamics of financial market, implied by a growing complexity of securities and services.

EU regulator introduced the renovation of European financial market through four separate moments<sup>21</sup>:

1. MIFID I, Directive 2004/39/EC
2. MIFID I, "Implementation act", Directive 2006/73/EC
3. Guidelines of CESR
4. Periodic controls of EU Commission

In the first moment EU Legislator defined general principle, on the opposite the *implementation act* takes care of specific situations that concern the regulation of investment firms and the implementation of transparency principle in the market. Guidelines settled by CESR are targeted to Member States, helping them in the convergence of the Directive.

This reform process wasn't oriented to regulate only financial advisory, but it contains also important elements that renovate the fields of intermediaries and trading venues in the European scenario. Anyway, the discipline of our interest is focused on financial advisory, and in specific way the advisory in the investment sector, which was modified by this directive. Investment

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<sup>18</sup> See section 1.3) Financial Transparency, page 24

<sup>19</sup> See Art.11, ISD

<sup>20</sup> Directive 2004/39/EC

<sup>21</sup> <https://eur-lex.europa.eu/legal-content>

advice is contained in Art. 4 of MIFID I<sup>22</sup> and it is defined as: “the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments”<sup>23</sup>. The main elements that design the new concept of investment advisory can be summarized in:

- Personal nature of service
- Centrality of Recommendation

The aspect of personal recommendation summarizes very well the intention of legislator to connect the new definition to the previous principle of investor’s centrality described in ISD already. The personal aspect of recommendation is better specified in the “*implementation act*” of MIFID I, in fact, the service provided shall be suitable for the person. It is the main point, and it must be based on the consideration of the whole financial context of that person. The recommendation is not considered personal if it is provided exclusively through distribution channel or to the public<sup>24</sup>.

At the same time MIFID introduces an important change for Intermediaries with a deeper orientation to advisory role. In this definition is clear how legislator focused his attention over the service provided. This was a structural change respect to the previous regulation and it is relevant because it changes the logic of the activity. The role of advisor is designed no more to sell a security but to sell a service. Moreover, investment advisory is settled by MIFID as an activity subject to approval, so all the rules of transparency and fairness must be respected by all the advisors that carried out the activity, deleting unbounded consultant from the market. The requirement for authorization define that the provision of investment service shall be granted by the competent authority of Member States<sup>25</sup>.

The legislator required some specific rules of conduct for intermediaries to respect in client’s relation:

- The intermediaries shall notify to clients that the investment firm has to distinguish the types of clients in three categories: Retail investor, Professional investor and eligible counterparty in accordance with principles settled in MIFID. The investment firm has also to notify to clients any right to request a different categorization and consequent limitation of client protection<sup>26</sup>.

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<sup>22</sup> If not better specified as “Implementation act” it is referred to Directive 2004/39/CE

<sup>23</sup> Art. 4 Directive 2004/39/CE.

<sup>24</sup> Art. 52 Directive 2006/73/EC.

<sup>25</sup> Art. 5 Directive 2004/39/CE

<sup>26</sup> Art. 28 Directive 2006/73/EC.

- Member states have to ensure that investment firms act in the best interest of the client, following the principles of honesty, fairness and professionalism. Moreover, it is forbidden provide an investment or ancillary service paying or being paid any fee, commission or non-monetary benefits. Inducements are approved only if it is designed to enhance the quality of the relevant service to the client, and not impair compliance with the best interest of the investor. The method of calculating of the fee or commission shall be disclosed to the client in a comprehensible manner<sup>27</sup>.
- The investment form shall provide to the clients, also through a summary form, a description of the conflict of interest policy maintained by the firm<sup>28</sup>.
- *Best execution criteria* design the execution of the order, made by investment firm, to obtain the best result for the client. This criterion implies for a retail client that the best possible result is represented by the price of financial instrument and the cost related to execution, which shall include all the expenses incurred by the client, which are directly related to order's execution<sup>29</sup>.

The assessment of suitability of the service required by the personal nature of the service described above is not left to the will of intermediaries but is well designed by the legislator in order to uniform the service. The Advisor has to understand the essential facts about the client in order to assess correctly the investment objective, financial capacity to bear investment risks and ability of the client to understand the risk. The information that needs to the advisor shall concern the financial situation such as the source of his income, his assets and others financial commitments. Are required to the clients also information about personal preference for the length of investment and previous experience in financial investment.

This framework for the regulation of advisory activity include specific rules for investment advisory and other, like for example the distinction in different categories of client, that are referred to intermediaries in general. The rules designed by MIFID are oriented to the protection of client through transparency, to achieve the wider perspective of a stable and harmonized European Financial market. The deadline for the reception of MIFID in Member States was settled the November 1<sup>st</sup>, 2007. Anyway, the Financial Crisis and the subsequent Recession had a strong impact on financial market, forcing the legislator to apply further changes in the subsequent years.

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<sup>27</sup> Art. 26 Directive 2006/73/EC.

<sup>28</sup> Art. 30 Directive 2006/73/EC.

<sup>29</sup> Art. 44 Directive 2006/73/EC.

### 1.2.2. Impact of Financial Crisis

MIFID I brought a lot of improvements in the European market, defining a common legislation aimed to stabilize the European Financial Market over a long period. The scenario of financial market suffered a huge crisis, emerged in September 15 of 2008 with the bankruptcy of Lehman Brothers. The crisis started a couple of years before the largest bankruptcy of US history, triggered by the system that built on subprime mortgages<sup>30</sup>. The impact wasn't limited to financial sector, but it was extended also to the real estate market, hitting hard especially the retail investors. The crisis became systemic with the infection of sovereign debts all around the world. It is hard to find some credible data about the world impact of the crisis across the years after 2008, but probably no quantitative data can reflect the most important defeat of financial system, the loss of confidence of investors.

Everything started in 2000, with the rise of new types of loans in the market, that constitutes the basic element of securitization<sup>31</sup> process. These products were present on the market since 1980s but they were not traded in a massive way. Loans were designed by Banks and granted by Banks and other intermediaries such as Independent brokers and non-depository institutions. Loans in USA market are not intended as European concept of mortgage, the differences are about the type of borrower and the repayment system. The categories of loan, besides mortgages, are huge and the description of some types is useful to understand that a subprime loan is not linked only to real-estate market<sup>32</sup>. An interesting type of loan is NINJA, that are referred to loans granted to borrower which has no job, no source of income and no assets, thus it can be considered an unsecured loan. Another type is the Adjustable Rate Mortgage (ARM) which have a strange repayment structure, characterized by a negative amortization of the Loan. In firsts periods borrower pays an amount of money also lower than interest part, and after some periods he starts to pay the mortgage rate composed by capital part and interest part. In this way the mortgage is affordable by everyone for the first period but involves multi-dimensional issues as the possibility to change repayment system. For example, after a given period it shift from the fix interest rate of repayment to a variable interest rate. Loans with collaterals different from real-estate property were spread in the market such as Student loan, Payday loan, Automobile title loan and Tax refund anticipation loans. Loans secured by real-estate property

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<sup>30</sup>“It is a loan with an high risk of default”, to deepen the argument: Y. DEMYANYK and O. VAN HEMERT *Understanding the Subprime Mortgage Crisis*, , The Review of Financial Studies, Volume 24, issue 6, June 2011.

<sup>31</sup> Securitization is going to be described in this chapter, to deepen the topic: A.B. ASHCRAFT and T SCHUERMANN, *Understanding the Securitization of Subprime Mortgage Credit*; T. PIRSKOSKI, A. SERU, V. VIG, *Securitization and distressed loan renegotiation: Evidence from the subprime mortgage crisis*, 2010, Journal of Financial Economics

<sup>32</sup> A. LUPOI, *Circolazione e contrabbando del rischio nei subprime loan*, 2015, Rivista di Diritto Bancario 7

were more suitable for the securitization process, but also other collateral were well accepted. A symbolic technique to produce more loans at the same time is known as “piggyback”, it consists in a double mortgage to cover the entire value of the real estate. The first mortgage covered the main percentage of the value, the second part was used to pay the residual part.

The granting of a loan shall be based on a creditworthiness rating of borrower, known as FICO score. FICO is represented by a value, from 300 to 850<sup>33</sup>, and it is based on:

- 35% Payment History
- 30% Debt Amount
- 15% Credit History
- 10% New Credit Line
- 10% Credit Mix<sup>34</sup>

A higher value defines better repayment capacity of the borrower thus a lower interest rate for the loan granted, this value is dynamic and can be updated after every missed payment of borrower. If Fico score of borrower is under the threshold of 500 the loan is considered subprime<sup>35</sup>.

### *Predatory Lending*

The market of loans was controlled by intermediaries which lent money in the market in an indiscriminate way. The loans were not held by lenders but were purchased by investment banks or vehicles which managed them through a securitization mechanism<sup>36</sup>. Since lenders were interested to gain more money through commissions, and the supply of loans were well supported the demand, intermediaries started to lend money in a non-discriminatory way. Intermediaries took the possibility to fraud borrower in order to grant more loans possible and they achieved this aim with a practice called Predatory Lending. There is not a fix definition of Predatory Lending, because it can be performed in different forms<sup>37</sup>. The lender which convinces in a deceptively way a borrower to accept unfair or abusive loan conditions is considered a predatory lender. Furthermore, it is considered predatory lending also the systematic violation of loans terms in ways that the borrower is unable to protect itself<sup>38</sup>. The

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<sup>33</sup> S. MEIER, C.D. SPRENGER, *Time Discounting Predicts Creditworthiness*, 2012, *Psychological Science* 23, page 57

<sup>34</sup> “Credit mix consider credit cards, credit accounts of retailer, installment loans, accounts in finance company and mortgage. It is not a main factor in the computation of FICO, but it assumes importance if others categories have not information”. Definition of my FICO.

<sup>35</sup> K. GERARDI, L. GOETTE, S. MEIER, *Numerical ability predicts mortgage default*, 2013, *PNAS*

<sup>36</sup> Described in this subsection, page 12

<sup>37</sup> S.I. FOODMAN, *Predatory Lending and Mortgage Fraud*, 2009, *Banking L.J* 126, page 254

<sup>38</sup> H. AMENT, *Predatory Lending: What will stop it*, 2012, *Law and Financial Market Review* 327.

matter is really complicated to define, but it is clear that is orientated to lend more loans possible in the market exploiting information asymmetries, abusing of borrowers. In fact, brokers and lenders have a wide knowledge of loan's options and opportunities which allow them to take advantage of the borrowers. Favorite targets of a predatory lenders shall be persons with a poor financial education and owners of a real-estate property<sup>39</sup>. The loan provided with the practice of predatory lending is designed in such a way that borrowers are not going to afford the payment<sup>40</sup> in long period, using types of product described above.

The borrower that after some years is not able to repay the loan is convinced by brokers to borrow money again, regardless of suitability of loan with Fico score of borrower. The refinancing of a loan is called "flipping" and it was common in that years. This practice is incentivized by additional fees for the broker, but at the same time, through flipping the equity is removed from the loan and do not provide any benefit to borrower<sup>41</sup>. The lender through the practice of "packing" adds also different ancillary services to loans, as for example insurance, which are not required by the borrower. The whole "industry" is oriented to make loans that borrowers shall refinance with other loans. In long period borrowers are unable to pay back loans due to high costs due to a Fico score on subprime class, thus designated to foreclosure practice<sup>42</sup>. The predatory lending had tangible effect estimated in 9 billion dollars a year<sup>43</sup> over borrower cost, and the number of subprime loans passed from 3% of loan in US during 2003 to 8% in 2004. The impact can be appreciated in Table 2<sup>44</sup>, which take in consideration the number of sub-prime loans with respect to all mortgages.

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<sup>39</sup> A. LUPOLI, *Circolazione e contrabbando del rischio nei subprime loan*, Rivista diritto bancario vol.7, page 7

<sup>40</sup> H. AMENT, *Predatory Lending: What will stop it?*, 2009, Journal of business & Technology Law , page 376

<sup>41</sup> A.B. FERGUSON, *Predatory Lending: Practices, Remedies and Lack of Adequate Protection for Ohio Consumers*, 48 CLEV. ST. L. REV. 607

<sup>42</sup> "Legal process by which a lender cancels (forecloses) a borrower's right of redemption of the mortgaged property through a court order, ..., the lender is free to sell the property. The borrower remains liable for the due amount if the property remains unsold, and for the shortfall if the sale proceeds are insufficient to pay off the entire debt." , Business Dictionary.

<sup>43</sup> K. EGGERT, *Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 507 (2002)

<sup>44</sup> Table 1.1 S. I. FOODMAN, *Predatory Lending and Mortgage Fraud*, 2009, Banking Law Journal 254.

Table 1. 1: shows the increasing number of subprime mortgages in years before the crisis

		All mortgages number serviced	Prime Loans Conventional number serviced	Sub-prime Loans number serviced	% of Sub-prime in the market
Q3	2007	45.417.215	35.224.689	5.990.253	13%
Q4	2006	43.481.826	33.322.667	5.971.363	14%
Q4	2005	41.234.414	31.143.532	5.527.341	13%
Q4	2004	39.306.561	29.255.227	4.852.040	12%
Q4	2003	37.233.278	28.363.266	3.112.058	8%
Q4	2002	33.798.985	26.009.913	1.293.132	4%
Q4	2001	32.558.320	24.309.888	868.813	3%
Q4	2000	30.510.925	22.195.265	808.339	3%
Q4	1999	29.618.847	21.504.493	570.069	2%

By the way, low creditworthiness of creditors was amortized by an efficient real-estate market until 2006. The non-judicial procedure of foreclosure in US market allow the creditor to sell collateral in a relative short period, one year, with a capital recovery around 70% or 80%, in conditions of efficient market.<sup>45</sup> Since demand of real-estate property was high the misleading behavior of lender was covered, and for long time predatory lending had real effects only on poor people which couldn't afford their home.

### *Securitization*

The predatory lending can be defined as a source of raw material for securitization mechanism. Securitization is a financial mechanism which integrates the market of loans, composed mainly by residential mortgages, with the capital markets<sup>46</sup>. The aim of this complex mechanism is to shift the mortgage risk on external investors, so risk of subprime mortgage is not suffered by the originator of loan but it is up to final investors. Securitization process is composed by different parts well represented in Figure 1, the first part has been explained already under the description of predatory lending, and it referred to the placement of loan in the market. At this point the Bank has a credit right, ensured by a collateral on the balance sheet, that shall be remunerated by future cash flow.

<sup>45</sup> M. BRENNAN, *America's New Foreclosure Capitals*, Forbes, 2012, "average of 348 days at national level", "(house) sell at a 24% of discount"

<sup>46</sup> K.C. ENGEL & P.A. McCOY, *Turning A Blind Eye: Wall Street Finance of Predatory Lending*, 2007  
75 FORDHAM L. REV. 2039, 2043



Anyway, the bank can't keep on balance sheet all the loans, since the remunerative activity is the intermediation, not the holding activity<sup>47</sup>. Holding of loans involves also a liquidity problem for banks besides problem of borrower's creditworthiness. Banks, to shift the risk, transfer the loans to Special Purpose Vehicle (SPV), the vehicle can be owned by the same owner of bank, but with a different legal entity. Loans acquired by SPV were packaged and classified in different tranches. The tranches created constitute the assets of SPV, that are called Asset Backed Securities (ABS) in this case. Since the majority of these layers contain residential mortgage were called Rental Mortgage Backed Securities (RMBS) which the SPV sold directly to investors or to another Vehicle that securitized them in Credit Default Obligation (CDO). At this stage the Vehicle manufacturer of CDO sell the products in the market to investors or to further steps of securitization process (another SPV), not represented in Figure 1<sup>48</sup>.

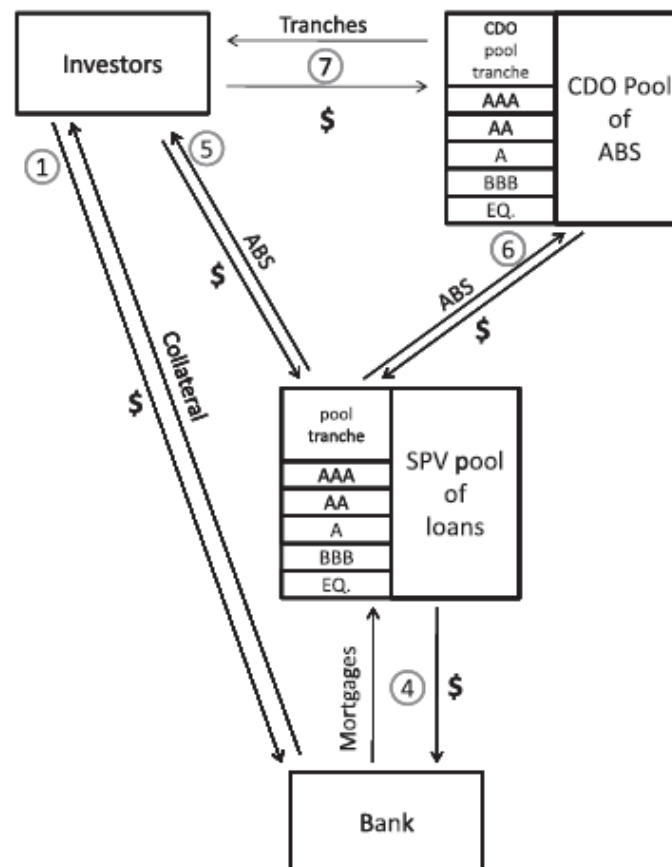


Figure 1. 1: Securitization process

Tranches that design ABS in general are assessed on the risk of default of mortgages that construct the effective underling of asset. However, the number of mortgages with high rating

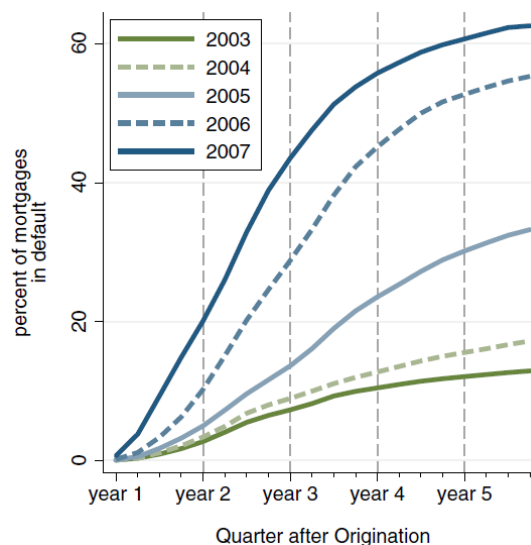
<sup>47</sup> G. GORTON, A. METRICK, *Securitized banking and the run on repo*, 2012, Journal of Financial Economics 104, page 431.

<sup>48</sup> G. GORTON, A. METRICK, *Securitized Banking and the run on repo*, 2012, Journal of Financial Economics 104, p 431, figure 6

(AAA) was limited and vehicles stated to put low ratings loans (D)<sup>49</sup> in assets that have mainly high rated tranches. These ABS were rated by external rating agencies as triple A even if in the assets were combined loans with higher risk and a spread around three percentage point<sup>50</sup>. This unfair process was implemented also for the further steps of securitization mechanism, bringing to the building of assets characterized by high rating and at the same time high risk of default of underlying mortgages, categorized as Subprime<sup>51</sup>.

Securitization process stated to be fraudulent with the provision of misleading information on the effective risk of the products. The opaque nature of the process is supported by the complexity of products, which is composed by different layers, facilitating the application of the fraud. Rating agencies assist the fraud allowing to intermediaries to obtain asset's rating untied from the real risk of products. The structure collapse with the deterioration of real-estate market. The slowing of the house market was influenced by the higher number of foreclosures, which had a negative impact on the neighborhoods' value<sup>52</sup>. The drop of demand ceases to sustain the financial system and thus the securitization process results unsecured.

Figure 1. 2<sup>53</sup>: Representation of increasing number of default in USA, cumulative percentage of default with foreclosure practice.



The financial system betrayed investors and borrowers combining in the same scheme predatory lending and securitization. The intermediaries essentially exploit the low level of authorities'

<sup>49</sup> The scale can vary according to different ECAI, but the most common follows these standards, see Regulation 2016/1800/EC for others kinds of ratings scale accepted in European Union.

<sup>50</sup> Y. DEMYANYK, O. VAN HEMERT, *Understanding the Subprime Mortgage Crisis*, 2011, The Review of Financial Studies 24

<sup>51</sup> G. GORTON, A. METRICK, *Securitized banking and the run on repo*, 2012, Journal of Financial Economics 104

<sup>52</sup> J.R CAGGIANO, T.G. FRANZEN, and L.M. HOWELL, *Subprime Mortgage and Predatory Lending Law Developments*, 2008, The Business Lawyer, page 638

<sup>53</sup> K. GERARDI, L. GOETTE, S.MEIER, *Numerical ability predicts mortgage default*, 2013, PNAS, Figure 1

supervision and the lack of adequate legislation to sell worthless assets to investors. The complete absence of transparency, at different levels of the system, and the consequent impotence of clients to make an informed choice, brought financial market to the financial crisis.

Events since 2007 revealed embarrassing blind spots in the pre-crisis understanding of the financial system by policymakers, and also by the academic community<sup>54</sup>. After the crisis took place a growing awareness that the price to pay for the mismanagement of moral hazard carried out by banking system, financial intermediaries and a weak response of public sector, was paid by retail investors<sup>55</sup>. The inevitable loss of confidence influenced the market also slowing down the process of economic upturn that the public sector tried to implement after the crisis, extending the recession period. The history of financial market taught us that every time, after a great recession the legislator modified the rules<sup>56</sup>, to avoid the recurrence of phenomenon. After G-20 of 2011 EU started a process of consolidation of banking sector with the creation of banking union; the aim was to stabilize the sector which was stressed by the crisis of sovereign debts. European Banking Union was designed on three pillars:

- Single Supervisory Mechanism (SSM)<sup>57</sup>
- Single Resolution Mechanism (SRM)<sup>58</sup>
- Deposit Guarantee Scheme (DGS)<sup>59</sup>

The priority given to banking sector's stabilization had negative effects on the confidence of retailer investors. The reform of banking system was implemented before the upgrade of investor protection since the banking crisis was a structural problem with higher risks connected and so legislator decided to give the priority to this reform. In this renovation was designed a practice called bail-in<sup>60</sup> used by legislator to eliminate the connection between banks and states in case of banking failure. The aim of bail-in is to reduce moral hazard and to increase the fairness in the conduct of bank management. Anyway, this practice increases the risk to bear losses for the investors and depositors but in the long run protect the taxpayer of the interested

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<sup>54</sup> Financial Reform after the Crisis: An Early Assessment, Nicolas Vernon, 2012

<sup>55</sup> BOCUZZI, *Gli assetti proprietari delle banche*, 2010

<sup>56</sup> P. ROSSI, *Il nuovo regime della consulenza finanziaria nella MiFID II: prime riflessioni*, Amministrazione in Cammino, 2017

<sup>57</sup> EU Regulation n 1024/2013

<sup>58</sup> Directive 2014/59/EU and EU Regulation n 806/14

<sup>59</sup> Directive 2014/49/EU

<sup>60</sup> "An arrangement in which creditors of a failing financial institution are required to cancel some of its debts as part of a plan to save it from collapse", Oxford Dictionaries. For Bail-in: Analyzing the Cumulative Impact of Regulatory Reform, Chapter 11: A critical evaluation of bail-in as a bank recapitalization mechanism, Charles Goodhart and Emiliós Avgouleas, 2015

State<sup>61</sup>. In a scenario where investors were stressed already, this reform cause a further deterioration of trust between market and investors.

Concurrently European institutions not limited their efforts for the renovation of banking system, but after strong critics received for the protection of retail investors due to blind spots emerged during the crisis, the EU Legislator decided to intervene one more time on the rules of financial market. The decision to review the recent MIFID I is imposed by the necessity to gain one more time the trust of investors, consumers and depositors. By the way, the lacks highlighted are not limited to trust of investor, but they include also the regulation of trading venues and the definition of securities, which with the raise of financial engineering are more complex.

### **1.2.3. Renovation of Financial Advisory through MIFID II and MIFIR**

The aim of all operations after financial crisis was defined in 2009 by the report: “*The high-level group of financial supervision in the EU*”<sup>62</sup>, that is mainly followed by EU Legislator. The report was direct to macro-objective such as the Structure of EU Authorities, the management of risks in the market and the regulation of deregulated sectors. After this report EU regulator started to modify not only MIFID, but also other aspect of financial market such as the control of rating<sup>63</sup> agencies and rules about edge funds, private equity and funds<sup>64</sup> different from Undertakings for Collective Investment in Transferable Securities (UCITS)<sup>65</sup>.

After the crisis, all the pressures described above bring to the revision of financial market structure settled some year before by MIFID I. A trilateral dialogue between EU Commission, EU Council an EU Parliament reach in January 2014 an agreement on the text of new Directive. The renovation is based on:

- Market in Financial Instrument Directive II (MIFID II)<sup>66</sup>
- Market in Financial Instrument Regulation (MIFIR)<sup>67</sup>

The introduction of the new directive is not a revolution of EU financial market, but an implementation of the existing framework designed in MIFID I, introducing important news

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<sup>61</sup> Effect of bail-in on investors’ trust market, Maurizio Mazzotta

<sup>62</sup> Reported by a group headed by Jacques de Larosière under mandate of EU Commission.

<sup>63</sup> Implemented already with Regulation 1060/2009 but fated to be modified.

<sup>64</sup> Modification of cited matters with Directive 2011/61/EU.

<sup>65</sup> Directive 2009/63/CE

<sup>66</sup> Directive 2014/65/EU

<sup>67</sup> Regulation n. 600/2014

aimed to strengthen market structure without distort markets' dynamics. The presence of Regulation implies the necessity to set a combination of rules not exposed to potential changes of Member States, giving less degree of freedom for the objectives considered strategic by the legislator. Anyway, MIFID II and MIFIR are based on the implementation of the principle of transparency in the European financial market to ensure a better investor's protection. The approach of legislator is based on the disclosure of aspects, about market and products, which are not clear or not easy to understand for the investor. European Parliament take the opportunity to set corrections in the market structure aimed to regulate also the spot light of previous rules. The main fields in which MIFID II and MIFIR operate are:

1. Definition area of application
2. Investor's protection
3. Regulation of market
4. Regulation of raw material derivatives
5. Relations with third countries

The activity of Investment advisory is subject to further modification, even if it was one of the main object of MIFID I. The main news about the advisor activity introduced by MIFID II are discussed below.

#### *Certificate of competence*

After the introduction of an authorization for the activity of advisory in MIFID I, MIFID II wants to define also standards of knowledge for people that work as investment advisor. In detail, the Directive requires that all investment firms, which carry out the activity of investment advisory, shall demonstrate to Competent National authorities that persons, which provide investment advice or give information to investors about financial securities or correlated services in behalf of the investment firm, have necessary knowledge and competence<sup>68</sup>. Each Member State must publish the standards and criteria that shall be used for the assessment. By the way there is an optional exemption in MIFID II, in fact it is possible for the Member States to choose, a national regulation different from EU directive if are respected two criteria. It is applicable National rules if the person in question is not allowed:

- To hold client securities or funds and to place himself in debt with his client

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<sup>68</sup> Art. 25 Directive 2014/65/EU

- To provide any investment service except the reception and transmission of orders in transferable securities and units in collective investment undertakings<sup>69</sup>

*Advisory on independent basis*

MIFID II introduce the possibility to provide the service of investment advice on independent basis. The introduction of this possibility enforces all advisors to specify to the investor if the type of advisory is independent or not<sup>70</sup>, respecting the principle of transparency. If advisor is independent shall provide to client a supply of financial securities wider enough to diversify type of products and also issuers or product provider, in order to ensure the independent nature of the service provided<sup>71</sup>. This rule allows to signal the absence of conflict of interest for the independent advisor and therefore investor's choice is not limited to securities offered by a single issuer linked to advisor. The aim of legislator is to ensure a higher degree of suitability<sup>72</sup> of the product respect to investors preferences. The investment firm have the possibility for the first time to provide at the same time two types of advisory, independent and non-independent. In this last case the advisor is not totally independent because give to investment firm a percentage of the commission received by the client and the fee linked to financial product in portfolio issued by the investment form<sup>73</sup>. Client has to pay attention at this borderline situation that we can define "hybrid" advisory. Anyway, this service on independent basis can be considered also a Fee-based Advice because the advisor receives fees only from the customer and not from any other third party<sup>74</sup>. In table 2<sup>75</sup> is contained the new structure of incentives and information that shall be given to the client about it.

The quality of investment advisory is diversified with the new incentive scheme, but until there is a commission-based advice there is not full protection from conflict of interest of advisor. After the ban on receiving commission the independent advisor increases the amount of fees. The remuneration of an independent advisor is about €150-350 per hour, in a small investor perspective do not make sense to choose this type of advisor, unless he wants to invest an

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<sup>69</sup> Art 3 Directive 2014/65/EU

<sup>70</sup> Art 24 Directive 2014/65/EU

<sup>71</sup> Art 24 Directive 2014/65/EU

<sup>72</sup> See page 27

<sup>73</sup> P. ROSSI, *Il nuovo regime della consulenza finanziaria nella MiFID II: prime riflessioni*, Amministrazione in Cammino, 2017

<sup>74</sup> T MJ MOLLERS, *European Legislative Practice 2.0: Dynamic Harmonization of Capital Markets Law — MiFID II and PRIIP*, SSRN.

<sup>75</sup> Table taken and translated by: M. SCOLARI, *MiFid2 and the new rules on inducements in financial services*, BANCARIA 6, 2015.

important sum of money <sup>76</sup>. The independent base advisory is an important new, but it seems that a large part of the population is excluded given the high commission to pay.

*Table 1. 2: Classification of incentives, it shows different incentives for different types of clients.*

<b>Classification of incentives and information to clients<sup>77</sup></b>		
	<b>MIFID II</b>	<b>Information to clients</b>
<b>Monetary Incentives</b>		
Advisor on Independent Basis	Prohibition of receiving and holding	Reporting Fees on individual basis
Advisor non-Independent	Acceptable (to increase quality of service)	Ex-ante detailed, Ex-post detailed and on individual basis
<b>Non-Monetary Incentives</b>		
Advisor on Independent Basis	Prohibition	
Advisor non-independent	Acceptable (to increase quality of service)	Ex-ante detailed, Ex-post detailed and on individual basis
<b>Non-Monetary Incentives of mild amount</b>		
Advisor on Independent Basis	Acceptable	Ex-ante, generic
Advisor non-independent	Acceptable (to increase quality of service)	Ex-ante, generic

#### *Execution only and Best execution*

The execution only is the possibility for the investment firm to execute only the transmission or the reception of client's order. This service is used by private person that has not a direct access to the market and so they need a service provider. Investment firm have to specify if the access to the venue is direct or indirect, and the only responsibility of the firm is the time that need to execute the transaction. In regime of execution only investment firm does not provide any type of judgement. The principle of Execution only complements the principle of Best execution, present in MIFID already. In MIFID II Best execution principle is recalled and it design that the execution policy shall be clear for the investor and shall be provided information about how orders will be executed by the intermediary for the client. Investment firm shall also provide for free information about price, costs, speed of execution for every security<sup>78</sup>. Moreover, shall be required information about the top five execution venues on annual basis, classified for financial instrument and trading volumes<sup>79</sup>.

<sup>76</sup> T MJ MOLLERS, *European Legislative Practice 2.0: Dynamic Harmonization of Capital Markets Law MiFID II and PRIIP*, SSRN

<sup>77</sup> M. SCOLARI, *MiFid2 and the new rules on inducements in financial services*, BANCARIA 6, 2015, page 57

<sup>78</sup> Art 27 Directive 2014/65/EU

<sup>79</sup> Art 27 Directive 2014/65/EU

Furthermore, MIFID II provide important principles of conduct for the provider of investment services, which were partially defined in MIFID already. The general principle of conduct requires that the provider of an investment service act fairly, honestly and professionally in accordance with the best interest of client<sup>80</sup> and complying with principles of suitability and appropriateness<sup>81</sup>. The legislator set this principle to design a behavior for which the advisor not only complies with the law but also helps the law to fulfill its ratio. In fact, there are a lot of behavior that are legal but potentially unfair. For example, an intermediary could not specify the different importance of signatures in the contract, because it is not obligated, but this behavior do not comply with the general principle of conduct, since it is not oriented to investor's protection. The best interest of the client assumes priority with respect to the interest of intermediary. This imply that the financial instrument shall meet the needs of target investor<sup>82</sup>, matching client profile of risk. This objective is an old target of legislator, settled in ISD the first time, but not yet achieved with MIFID. By the way, the advisor needs information to create the risk profile of investor and at the same time has to provide information about securities to the client. MIFID II settled appropriate instrument to make possible this exchange of information between advisor and investor. The principle of transparency assumes a main role in MIFID II. The Advisor shall ensure more information about the security to the client and at the same time investors have to be more transparent with advisor to receive a more suitable advice.

### **1.3. Financial Transparency**

Transparency is the main topic concerning the client protection, since, as described previously, it plays an important role in the disclosure of the hidden aspect of the financial market. In section 1.2.2 is analyzed the way in which the financial crisis hit the market. The complete absence of transparency has supported the fraud of financial system towards the investors. By the way transparency is ever been one of the main objective of European legislator, it was cited in Financial Market Action Plan of 1999, in ISD and also in MIFID but every attempt to establish a lasting legislation failed or was amended. Financial transparency is characterized by the accessibility and visibility of information concerning business<sup>83</sup> which shall disclose the aspect of interest. Information have to be provided to investors with the correct timing, the European legislator; in fact, specify that the investor or the potential investor shall be informed

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<sup>80</sup> Art 24 Directive 2014/65/EU

<sup>81</sup> Art 25 Directive 2014/65/EU

<sup>82</sup> Art 24 Directive 2014/65/EU

<sup>83</sup> Merriam-Webster Dictionary



in “good” time before the provision of the service<sup>84</sup>. At the same time provider of the service has not to hide information in active way, being honest with respect to investors. The implementation of the general principle of transparency aims at clients’ protection through the correct conduct of intermediaries. The legislator is so focused on the provision of useful information to investors to fill the informative gap between advisor and investors that in the recent history has designed an unbalanced relation. Transparency is not linked only to financial performances of product but involves the aspects that concern the investment. Information are the cornerstone of financial market and so the implementation of transparency principle was pursued not only to protect investors but also to design a more efficient market. Financial analysts all over the world take investment decision based on information available, but in complete absence of information also a person that have a high financial education is unable to take a choice<sup>85</sup>. The provision of information is the only way in which the legislator helps the investor because do not influence the free will of investors but at the same time give the instruments to take a better decision since it is based on reliable information. The implementation of transparency regime through disclosure tools shall be designed to provide a tangible improvement to the investors’ decision making and this aspect is not obvious for the legislator. Thus, the main concern of the authority is to design a single layer of information that could be reliable for different kinds of investors present in the market. The higher barrier to reach this goal is represented by the capacity of different investors, with different level of financial education, to understand and exploit data in order to achieve the best choice in relation to preferences.

In order to solve this issue in MIFID I the legislator define different types of client, and the main distinction is between Professional and Retail client. This differentiation is recalled by MIFID II that is actually in force and recognize as professional those clients with a level of market knowledge and experience appropriate to make a personal evaluation of the risk and a consequent own investment decision<sup>86</sup>. There is a list of entities that shall be regarded as professional; it includes: entities which have to be authorized or regulated to operate in the financial market<sup>87</sup>, national and regional governments, institutional investors whose the main

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<sup>84</sup> Art 24 MIFID

<sup>85</sup> C. MALLIN *Editorial*, The Relationship between corporate governance transparency and financial disclosure, 2002, *Corporate Governance: an international review* V 10

<sup>86</sup> ANNEX II, (II), MIFID II

<sup>87</sup> (a) Credit institutions; (b) Investment firms; (c) Other authorized or regulated financial institutions; (d) Insurance companies; (e) Collective investment schemes and management companies of such schemes; (f) Pension funds and management companies of such funds; (g) Commodity and commodity derivatives dealers; (h) Locals; (i) Other institutional investors.

activity is investing in financial securities and companies, which match two of the following requirement:

- Own Funds € 2.000.000
- Net Turnover € 40.000.000
- Balance Sheet total € 20.000.000

The client categorized as professional has a lower degree of protection since it is considered completely able to assess the risk of the investment. However also for professional clients there is the possibility to ask for a higher level of protection. Before the provision of the service the investment firm must inform the clients that is classified as professional on the basis of available information. The client, that must be informed by bank about the possibility to obtain a higher degree of protection, is considered responsible to ask a different treatment if it deems to not be able to act as a professional client.

The retail client is defined by process of elimination, so all the agents or individuals which are not recognized as professional are retailer. Anyway, a retailer can ask to be recognized as professional client to gain more kind of transaction available by sacrificing the higher protection. A simple request is not enough, the bank shall make a serious assessment on quantitative and qualitative aspect. The assessment is based on the comply with the two over the three subsequent criteria<sup>88</sup>:

- Transaction frequency; 10 transactions of average for each quarter in last four quarter.
- Financial instrument portfolio, cash and financial instrument, € 500.000.
- Client works or has worked in financial sector for at least one year.

The advisor shall communicate to the client that want to shift from retail to professional the differences in the treatment before the decision of the investor. This important distinction between different types of clients, identifies the investors who need more protection.

The transparency regime is implemented especially in pre-trading activity, since it is the moment in which the investors needs information to take the investment decision. EU legislator settled two main principle of conduct to design a more transparent environment: Appropriateness and Suitability.

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<sup>88</sup> ANNEX II, (II), 1, MIFID II

### *Appropriateness*

The principle of appropriateness shall be applied for services different from portfolio management<sup>89</sup> and investment advice; the investment firm shall ask to client information concern the experience and the knowledge about the specific product or service that is object of the operation. In response to the information collected by the client the investment firm shall evaluate the appropriateness of product or service<sup>90</sup> provided. If it does not result appropriate for client or potential client, the investor shall be made aware about inappropriateness. Clients could also refuse to provide the necessary information for the evaluation of appropriateness, in this case the investment firm have to warn the investor about the impossibility to perform an evaluation. By the way, this principle is not binding for the client. Whether the bank aware the investor about the mismatch with the principle of appropriateness, but the client has the will to proceed with the operation the bank can proceed. The application of this principle requires a low level of information, it is applied in case of reception and transmission of orders and the execution of order in behalf of the client<sup>91</sup>.

### *Suitability*

The criterion of suitability is referred to activity of portfolio management and investment advice, in these cases the influence of advisor over the investment decision is more relevant because the investment firm shall suggest an investment option for the client. The nature of the service is different from appropriateness. The advisor shall not execute an investment decision took already by the client, but it has to provide a personal recommendation for the specific needs of the client<sup>92</sup>. In order to respect the principle of suitability the investment firm shall collect all the information about the experience and knowledge of investor in financial market, in line with the appropriateness, and further information about the financial situation:

- Investment objective
- Ability to bear losses
- Risk tolerance<sup>93</sup>

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<sup>89</sup> “Means managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments”, Art 4 MIFID II,

<sup>90</sup> Art 25 (3), MIFID II

<sup>91</sup> “act to conclude agreements for one or more securities in behalf of the client” Art 4, (5), MIFID II.

<sup>92</sup> Art 4, MIFID

<sup>93</sup> Art 54 (2) Regulation 2017/565/EU

The principle of suitability required more specific information because it aims to define the risk profile of the investor, that is a pillar to obtain a perfect match between personal recommendation of advisor and personal needs of client. This principle represents the centrality of the client in investment advisory. The essence of activity is the determination of client's profile, that shall be matched by the investment strategy recommended by advisor.

The EU legislator to guarantee the protection of retail client set the general principle of conduct<sup>94</sup> to define the centrality of the client and designing the behavior and standards of transparency that the advisor has to respect. Defining the principle of appropriateness, and in particular the principle of suitability the regulator establishes the way in which the objective shall be achieved. The complementarity of Art 24 and Art 25 of MIFID II is totally oriented to ensure to investor the most transparent situation. MIFID II design a double flow of information, first consolidate the flow from advisor to investor to guarantee a fair and honest description of the financial instrument. Secondly from investor to advisor in order to allow the investment firm to assess the risk profile of investor, fulfilling the suitability principle. With the purposes to applicate these principles are settled important instrument for the information collection and for the information provision.

### **1.3.1. Context of Application**

#### *Prospectus*

The implementation of transparency principle in the market is not started with MIFID II but it was an objective pursued also by rules that anticipate this last Directive. The protection of the client was structured at European level for the first time through the Prospectus<sup>95</sup>, a disclosure document, defined in Directive 2003/71/EU. Prospectus is not an obsolete instrument since the directive, which define it, is still in force even if it's settled fifteen years ago. This document is the first answer of legislator to asymmetric information problem between advisor and client and it contains a huge amount of information. Prospectus is aimed to provide information that the client should uses to assess the investment in a fully informed way. Furthermore, the information shall be presented in an easily analyzable and comprehensible way, in order to allow to investor with a low level of financial education to understand the data. Prospectus is not designed only for the investors protection, in fact the admission of a security to trading activity is linked by the publication of prospectus in all regulated market situated or operating

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<sup>94</sup> See at p.24

<sup>95</sup> See page 9

inside European Union<sup>96</sup>. Prospectus is a document with a validity of twelve months from the publication but only if it is complete of all supplements required. Validity depends also by kind of prospectus, whether it is composed by separate documents, the validity of the document follows other rules. The documents that composed prospectus are<sup>97</sup>:

- Registration document
- Securities note
- Summary note

These documents contain all information about issuer, characteristics of securities, essential risk and they shall be written in comprehensible language. In this situation all the documents shall be updated every 12 months, if one of the documents needs an update but it is not updated the prospectus can be considered not valid. The updating of prospectus is not limited to the annual validity, but it shall be modified every time that a new factor, an inaccuracy of information and a material mistake included in a prospectus or in a single part of it can affect securities' assessment.

The approval of Prospectus is managed through the principle of home State Control. The home Member State is always the state in which the issuer has its registered office, and so the competent authority for the approval and update of security<sup>98</sup>. This means that issuers of securities shall always apply the authorization of prospectus at the competent authority of the state in which registered office is situated. Without approval prospectus can't be published, and so also the security can't be sold in the regulated market. After the approbation the document shall be filed and made available to the public<sup>99</sup>, this operation shall be made in good time respect to the effective offer of the security. The availability of prospectus is provided through the publication in one of the channels settled by legislator. It can be considered available to the public if it is published in one or more newspapers with a wide circulation in the Member States<sup>100</sup>, where the offer is available to the public or it is admitted to trading. Also, the printed form is considered a tool of publication and can be available or in issuer's office or in the office of the market in which the security is admitted<sup>101</sup>, free of any charge. The last publication form available is the electronic one<sup>102</sup> and can be published on the websites of issuer, regulated market in which is admitted or competent authority of member state.

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<sup>96</sup> Art 3 Directive 2003/71/EU

<sup>97</sup> Art 5 (3) Directive 2003/71/EU

<sup>98</sup> Art 13 Directive 2003/71/EU

<sup>99</sup> Art 14 Directive 2003/71/EU

<sup>100</sup> Art 14 (2) (a) Directive 2003/71/EU

<sup>101</sup> Art 14 (2) (b) Directive 2003/71/EU

<sup>102</sup> Art 14 (2) (c) (d) (e) Directive 2003/71/EU

Prospectus shall be written in a language considered acceptable by the home member state. The offer to the public or admission and the main points that shall contain<sup>103</sup> are:

- Identity of directors, senior management, advisers and auditors
- Key information about the issuer
- Information on the company
- Operating and financial review and prospects
- Directors, senior management and employees
- Major shareholders and related-party transactions
- Financial information
- Additional information<sup>104</sup>

Directive 2003/71/EC modernized and harmonized disclosure requirements helping to create a financial market more uniform across Member States. The essential improvement is given by the creation of a document that constitute a sort of passport for primary market activities. This huge amount of information could not be suitable for the investors' assessment because the amount of information is not always directly proportional to the comprehension<sup>105</sup> of financial products.

### *Questionnaire*

The principles of appropriateness and suitability defined in MIFID I and recalled in MIFID II open a new mandatory channel of information's exchange between client and intermediary. The information collected from the investor are important before the subscription, during the contract and after the end of the contract to define and match the profile of investor. The information required by MIFID II shall be obtained but is not better specified the way in which investment firm must fulfill this duty. The assessment of appropriateness can be defined as a sub-case of the suitability since that knowledge and experience, that are field of investigation of appropriateness are included in the information required for the assessment of suitability. The set of data required by suitability questionnaire is wider because the investigation field is not limited to general knowledge and experience, that are useful to assess the investor's capacity to tolerate risk. In fact, investor has to provide information also about the financial capacity to bear losses and the objective of investment activity. Another main difference between suitability and appropriateness questionnaire is that the first is compulsory for the performance

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<sup>103</sup> Annex I Directive 2003/71/EU

<sup>104</sup> See Appendix 3 to have an idea of the amount of information contained in Prospectus.

<sup>105</sup> K. L. KELLER; R. STAELIN, *effects of quality and quantity of information on decision effectiveness*, 1987

of the activity. However, the directive does not lay down further rules over the general principles settled in Art 24 and 25 of MIFID II. The specific content or layout of questionnaire is not defined by legislator and each advisor is the manufacturer of own questionnaire. The lack of standardization let large degree of freedom to the investment firm that shall design the questionnaire to satisfy the general requirement, but it has not tight limit to observes. Different investment firm can determine different questionnaire for clients with respect to competitors<sup>106</sup>. This aspect could represent a limit for the protection of clients because the result of the questionnaire determines the risk profile of client that is the main measure for the application of suitability principle. In fact, the main risk for this system is to obtain different results from different questionnaire filled by the same investor. Anyway, general guidelines of MIFID are integrated through the regulation 2017/565/EU which define more detailed information that shall be contained in questionnaire<sup>107</sup>:

- |                        |  |
|------------------------|--|
| Investment objective   | <ul style="list-style-type: none"><li>• Preference over length of investment</li><li>• Preference about risk taking</li><li>• Purpose of investment</li></ul>  |
| Ability to bear losses | <ul style="list-style-type: none"><li>• Source of regular income</li><li>• Investment, real-estate property and assets</li><li>• Financial commitments</li></ul>   |
| Risk tolerance         | <ul style="list-style-type: none"><li>• Volume, length and frequency of previous transaction</li><li>• Previous experience with financial services</li><li>• Profession and level of education</li></ul> |

The number of question to disclose these information is not defined, in Italy there are questionnaire with a minimum of 9 and a maximum of 36 question, and an investigation performed<sup>108</sup> shows that only one case over fourteen satisfy completely the principles defined in MIFID II<sup>109</sup>. The interpretation of directive plays a crucial role; thus, banks could be focused on an aspect emphasizing for example the source of income and neglecting the portfolio

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<sup>106</sup> Determined by the lack of further information in legislation.

<sup>107</sup> Art 54, Art 55 Regulation 2017/565/EU

<sup>108</sup> N. MARINELLI, C. MAZZOLI, Profiling investors with the MiFID: current practice and future prospects, Research paper.

<sup>109</sup> N. MARINELLI, C. MAZZOLI, Profiling investors with the MiFID: current practice and future prospects, Research paper.

composition of the client for example. The competence of front office influences the questionnaire since it is the reference point in communication between bank and client. Moreover, questionnaire is influenced also by the type of bank that draw it up, the commercial bank has a lot of differences with respect to investment bank which influence the goal of the questionnaire. In fact, a different category of securities and client define different orientations for the bank. Differences between questionnaires are also due to the existence of questionnaire for client before MIFID II, so bank carry out the previous format also after the introduction of directive. The miss alignment with the directive produce a diversification among questionnaire that produce a negative effect over investors, difficult to estimate. The introduction of the mandatory questionnaire is an important step from the legislative point of view in the field of client protection. Anyway, the lack of standardization and the large degree of freedom lets to bank the possibility to customize the questionnaires and thus also results. In conclusion there is risk that the final results are not uniform in the market and since client profile has a crucial role in protection, advisors have potentially rooms to influence the result of questionnaire, and thus the risk of investment.

#### *Impacts of Behavioral Finance over MIFID Questionnaire*

The process which define the risk profile of client can be influenced by different aspects, but the main impact is due to irrational behavior of agents; it is based on observation of individual's choices which violate the hypothesis of rational behavior<sup>110</sup>. This discipline investigates how in certain cases individuals are unable to understand the available information and it highlights that in uncertainty conditions individuals act following approximate rules, called heuristic. Individuals' behavior under uncertainty can be classified in three different sections: familiarity, representativeness and anchoring. Essentially, under uncertainty, preferences are not stable and so they can change in different context. This aspect is relevant for my purpose since it describes a misalignment between objective risk, perceived by rational individual, and relative risk, perceived by individual under uncertainty. In this kind of condition, the environment plays an important role influencing individuals. The misalignment is due to the overestimation or underestimation of probability associated to a given situation or event<sup>111</sup>. An immediate example which link financial behavior and MIFID questionnaire is the phenomenon of overconfidence. In questionnaire some questions are about the self-evaluation of client's ability

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<sup>110</sup>N. LINCiano, la consulenza finanziaria tra errori di comportamento e conflitti d' interesse, 2012, ANALISI GIURIDICA DELL' ECONOMIA

<sup>111</sup> N. LINCiano, P. SOCCORSO, La rilevazione della tolleranza al rischio degli investitori attraverso il questionario, CONSOB discussion paper, 2012, p.10



to understand the risk of a financial product. The individual assesses own ability with a higher rate respect to the effective ability since he is incentivized to evaluate himself over the perceived average of the sample<sup>112</sup>. The evaluation of risk is influenced also by the source of income that is object of investment; in fact, whether the source is a gain derived from other investment or a cash winning the risk perceived is lower<sup>113</sup>. A similar modification of risk perceived can be influenced by the final objective of investment because if it is aimed to recover a previous loss the risk perceived is lower by the investors<sup>114</sup>. Also, the intertemporal factor is influenced by the amount of money invested, an individual under uncertainty shall estimates a stable discount factor but inverse with respect to amount of the investment. Thus, the evaluations of client are distorted by multiple emotional factors and environmental conditions. These distortions are computed and investigated through two types of tools, economic tools based on quantitative analysis and psychological tools. These biases have a strong impact on evaluation of risk profile of client, undermining the correct estimation of risk tolerance. Whether risk profile is wrong the whole process of suitability is affected by the uncorrected estimation and the match with the risk of product shall not satisfy the real needs of the client.

The source of bias is not limited to client's perception of risk but also by the structure of questionnaire. The absence of a standardized questionnaire and the presence of wrong question structure respect to literature's findings increase the possibility of an incorrect estimation. For example, risk tolerance is a composite measure, but some questionnaire investigates different factors<sup>115</sup>, which influence this measure, with a unique question, ruining the measurement. These problems are translated in non-uniform questionnaire across different advisors, thus as demonstrate by a survey carried out by *Autorité des marchés financiers* (AMF) over 1500 individuals<sup>116</sup>.

ESMA in 2011 issues further guidelines<sup>117</sup> to correct the pattern highlighted in the section above, it reiterates the aim of questionnaire stressing the point of client's centrality. It is the

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<sup>112</sup> The same example could be taken for individual which underestimate their ability under the average of the sample.

<sup>113</sup> This phenomenon is known as "House money effect", described in a deeply way in: R.H. THALER, E. J. JOHNSON, *Gambling with the House Money and Trying to Break Even: The Effects of Prior Outcomes on Risky Choice*, MANAGEMENT SCIENCE, p 643

<sup>114</sup> "On the contrary if there is the risk to close under the break-even point the risk perceived is higher by the investors", J. GRABLE, R.H. LYTTON, *Financial risk tolerance revisited: the development of a risk assessment instrument*, FINANCIAL SERVICE REVIEW, 1999, p 171

<sup>115</sup> The literature suggests that a financial risk-tolerance assessment instrument must include at least five elements: 1) some central concept of risk, 2) allowance for the derivation of risk measure, 3) relevance to respondents, 4) ease of administration, and 5) adequate validity and reliability, K. R. MAC CRIMMON, D.A. WEHRUNG, *Assessing Risk Propensity*, 1986 THEORY AND DECISION LIBRARY.

<sup>116</sup> See page 30

<sup>117</sup> Guidelines on certain aspects of the MiFID suitability requirements, Dicembre 2011, Esma/2011/445

answer to the critics highlighted by various investigation of supervisors which describes the inappropriateness of questionnaire. ESMA guidelines shall help the client to understand the importance of information in the design process of risk profiling and at the same time define that the client shall only provide information and do not decide his or her level of suitability, in fact it is a role of the intermediaries. At the same time a CONSOB's<sup>118</sup> interview asked to Italian intermediaries if the questionnaires are designed by expert in the fields of economy, psychology and statistics. Moreover, asked whether the questionnaire was tested with a sample or not. The results of this interview highlighted that the largest part of questionnaire in Italy are in line with the principles defined in MIFID, by the way the variables investigated are only a sub-section with respect to the variables suggested behavioral finance.

### *Key Investor Information Document*

The legislator settled two important documents, prospectus to provide information to client and questionnaire to collect information necessary to define the risk profile of investor. However, the complexity and the huge dimension of prospectus does not allow to link in a direct way the information contained in the disclosure document and the risk profile defined by questionnaire. The synthetic output of questionnaire requires a suitable measure of risk to compare security profile and client needs. Directive 2009/65/EU design a new tool to investors<sup>119</sup> aimed at providing only crucial information to investors<sup>120</sup>. Investment company shall draw up a document which contain key information<sup>121</sup> useful for assessment of investor in the UCITS. A general definition of UCITS can be useful to understand the niche of products that shall be supported by KIID. UCITS are pooled form of investment<sup>122</sup> managed by the manager of fund that collect money in the market. The document shall be written in briefly way with a non-technical language, in such a way that retail investor has not obstacles to comprehension<sup>123</sup>, in fact the comprehension of client shall be facilitated avoiding the use of technical terms if a "everyday"<sup>124</sup> words can substitute it. Information provided shall be summarized in no more than two pages of A-4 size in printed form<sup>125</sup>. The ratio of legislator is to provide a more direct

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<sup>118</sup> National Commission in matter of society and exchange, (commissione nazionale per società e borsa)

<sup>119</sup> Implemented by Regulation 583/2010 that define technical standards

<sup>120</sup> Art 78 (2) Directive 2009/65/EU

<sup>121</sup> Art 78 (1) Directive 2009/65/EU

<sup>122</sup> P.J. PAUL, *The European Community's UCITS Directive: One Model for United States Regulatory Change in a Globalized Securities Market*, 25 Vand. J. Transnat'l L. 61 (1992)

<sup>123</sup> Art 78 (5) Directive 2009/65/EU

<sup>124</sup> Art 5 (1) (b) (III) Regulation 583/2010

<sup>125</sup> Art 6 Regulation 583/2010

communication of information respect to prospectus, that is a huge document that in some cases has an important length<sup>126</sup>. The information summarized in KIID shall be<sup>127</sup>:

- Identification of UCITS
- Objective and policy of Investment
- Performance, past and future scenario
- Charges and cost
- Risk profile and associated return of investment

The application of Key Investor Information Document shall be laid down by manufacturer of the product but is the advisor that have to present it to client in order to respect the general principle of conduct. The directive entered in force from 1 July 2011.

The introduction of KIID for a niche of products, paved the way for another important disclosure document, the Key Information Document (KID)<sup>128</sup>. It is a disclosure document based on the general principle of KIID but that cover a wider range of product called Packaged Retail and Insurance-based Investment Products (PRIIPs) and is going to be explained in deeply way in chapter 3. The framework applied by EU to ensure a transparent financial market is based on three pillars. Prospectus needs to guarantee a huge quantity of information which can be used by investor for a deep analysis of the instrument, and at the same time ensure a unique passport for the securities traded in EU financial market. The second level of documentation available for the investor is represented by KIID and KID, oriented to provide a synthetic in immediate information about the essential aspect of securities. The last tool is questionnaire use by Advisor to assess the profile of investor. The structure is designed to highlight the risk of securities and the risk's profile of the investor, in this way the suitability of operations is understandable in an easy way, looking at the match between them, even if the products traded are complex. This new system aimed to protection of investors required a higher amount of information to advisor and manufacturer as to investors, which imply higher costs for intermediaries and higher risk in term of consumer's privacy<sup>129</sup>.

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<sup>126</sup> See Appendix 3

<sup>127</sup> Art 78 (3) Directive 2009/65/EU

<sup>128</sup> Regulation 1286/2014/EU supplemented by Regulation 2017/653/EU that design technical standards

<sup>129</sup> M. Janssen, J. VAN DEN HOVEN, *Big and Open Linked Data (BOLD) in government: A challenge to transparency and privacy?* 2015 , Government information quarterly 32, page 363

## 1.4. Impact of MIFID and MIFID II in Italy

The adjustment of national legislation, aimed to adopt MIFID, was implemented at three different level of national regulation. The legislative decree n. 164 in 2007 modified TUF<sup>130</sup>, the improvement of Intermediaries' Regulation and Market's Regulation performed by CONSOB and the elimination of Regulation about organization and procedures of intermediaries which conduct investment service or collective management of savings<sup>131</sup> operated by CONSOB.

The implementation of MIFID presents some differences with the rules settled by European legislator. With regard to the opportunity for persons to perform investment advice the National legislator didn't provide any adjustment until the modification in 2009<sup>132</sup>, which implement this possibility in line with MIFID. In the field of "financial promoter"<sup>133</sup>, the Italian regulation didn't allow to manage funds or securities on behalf of investment firm's client, in contrast with the European Directive that allow this kind of mansion. In Italy the activity of financial advisor was allowed only to dependent of Banks and Investment firms. The other content of MIFID are implemented in line with the ratio of EU Regulator. One of the most important point of implementation about financial advisory is the article 18 of TUF in which is defined the financial advisor and the constitution of a register for persons that operate as financial advisor. The persons shall respect standards of professionalism, independence and capital<sup>134</sup>.

Another modification of TUF occurred with the reception of MIFID II in 2016 through deliberation of CONSOB n. 19548 which impact especially on Intermediaries' Regulation, Issuers' Regulation and Advisor's Regulation. The implementation of a certificate of competence<sup>135</sup> for financial advisor is contained in Art 6 of TUF. The figure of independent advisor<sup>136</sup> was defined by Italian legislator as "autonomous" advisor, and the new rules about incentives was adopted in line with MIFID II with two regulations of M.E.F.<sup>137</sup>. The others important modification about independent advisors are well integrated in national law with the Advisor's Regulation at art. 17. The general reception of MIFID II has less discrepancies with

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<sup>130</sup> It is the text of dispositions in matter of Financial intermediation, Legislative Decree n. 58/1998 TUF

<sup>131</sup> Operation of CONSOB in accordance with Bank of Italy.

<sup>132</sup> Art 18 (ter) TUF

<sup>133</sup> Art 31 comma 2 TUF

<sup>134</sup> Art 18 (bis) (ter) TUF

<sup>135</sup> Described at p, 17 section *Certificate of competence*

<sup>136</sup> See sub-section "advisor on independent basis" p 22

<sup>137</sup> Decree of Economic Ministry n. 206/2008 denominated "Regolamento di disciplina dei requisiti di professionalità, onorabilità, indipendenza e patrimoniali per l'iscrizione all'albo delle persone fisiche consulenti finanziari" and Decree of Economic Ministry n. 66/2012 denominated "Regolamento di disciplina dei requisiti patrimoniali e di indipendenza delle società di consulenza finanziaria".

respect to reception of MIFID I, an important role is played by the presence of more regulation in the second directive which imply a more rigid application of rules defined by EU Regulator.



## 2. Packaged Retail Insurance –Based Investment Products

At our days' investment market scenario is rich of products structured in a complex way, that usually are not easy to understand for clients. A lot of banks offer products to retail investors, even if these subjects are not able to realize in which way their money are invested and consequently, the real risk of the investment. The core of this products is represented by packaged retail insurance-based investment products, otherwise identified with the acronym "PRIIP". There is not a specific definition or a rigid legal form which defines PRIIPs, but this class of product is established with process of elimination.

The main characteristic which define a PRIIP is the nature of the repayable amount which is subject to fluctuation linked to performances of one or more assets exposed to reference values, not directly purchased by retail investors<sup>138</sup>. Another characteristic, that could be also infer by the name, is the "packaged" nature of the product that is built through a sort of wrapping mechanism. This mechanism may have different nature such as pools of capitals, reference rates or use of derivatives. It basically allows to the manufacturer of the products to combine multiple assets exposures, obtain ad hoc costs structure or design unique product features. The aspect that concerns to "insurance-base" is referred to insurance product linked totally or partially to market fluctuation and they contain capital guarantees or insurance of other nature, linked to an investment operation. Products shall be considered PRIIP even if they are not packaged, is enough that the maturity or renunciation value is linked to fluctuation of the market, in this case the product is classified as an Insurance-based investment product<sup>139</sup>. On the other side another sub-category of PRIIP are PRIP and so "packaged retail investment product", which do not include insurance-based products but are composed by products issued by SPV<sup>140</sup> or securitization special purpose entities<sup>141</sup>, and they respect the main characteristic of PRIIPs. This category of instrument is oriented to perform better than risk-free rate in a medium or long-term investment horizon.

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<sup>138</sup> Recital 6, Regulation 1286/2014

<sup>139</sup> Art 4 (2), Regulation 1286/2014

<sup>140</sup> Definition: 'special purpose vehicle' means any undertaking, whether incorporated or not, other than an existing insurance or reinsurance undertaking, which assumes risks from insurance or reinsurance undertakings and which fully funds its exposure to such risks through the proceeds of a debt issuance or any other financing mechanism where the repayment rights of the providers of such debt or financing mechanism are subordinated to the reinsurance obligations of such an undertaking. Art 13 (26) DIRECTIVE 2009/138/EC

<sup>141</sup> Definition: securitisation special purpose entities' means entities whose sole purpose is to carry on a securitisation or securitisations. Art 4 (an) Directive 2011/61/EU

The category of PRIIPs do not include:

- Non-life insurance products<sup>142</sup>
- Life insurance with benefit payable only on death, sickness or injury.
- Non- structured deposits
- Securities<sup>143</sup>
- Pension product with primary purpose of providing retirement income
- Occupational pension schemes, officially recognized by EU Parliament and Council<sup>144</sup>
- Individual pension products

In this way we can identify PRIIPs as a horizontal category of products that excludes: products without investment risk, direct holding of shares and bond, deposits other than structured, general insurance with benefits payment only on death or incapacity and pension product or fund with primary purpose retirement income.

## 2.1. PRIIPs' Categories

The European Commission identified four main categories of PRIIPs: Investment funds, Insurance-based investment products, Retail structured securities and Structured term deposit<sup>145</sup>.

### 2.1.1. Investment Funds

The investment fund is an amount of capital composed by investments of numerous clients pooled in a collective way. It could be perceived also as investment product with the aim to collect investor's capital. Investment funds play an important role in accumulation of personal savings. Investor owns complete control of his own shares but can't decide how to dispose assets owned by the fund. Decisions about assets that should be purchased or sold are taken by the manager of the fund. EU regulator laid down different categories of funds to create a market free from barrier for investment fund. Directive 2009/65/EC defines Undertakings Collective

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<sup>142</sup> All classes in Annex I Directive 2009/138/EC

<sup>143</sup> Securities defined at Art 1 Directive 2003/71/EC

<sup>144</sup> Included pension funds within the scope of Directive 2003/41/EC or Directive 2009/138/EC.

<sup>145</sup> EU MEMO/14/299, 2014



Investment in Transferable Securities. UCITS cover 75% of collective investment by small investors in Europe and it includes investments in transferable securities or other asset specified managed under the principle of risk-spreading<sup>146</sup>. Units of UCITS shall be repurchased or redeemed, in a direct or indirect way on request of the holder. The value of UCITS' stock exchange value shall be strictly anchored to net asset value, in different case this value is regarded as equivalent value of repurchase or redemption<sup>147</sup>. There are also other types of funds in the market, which are not regulated by UCITS directive. Alternative investment fund managers (AIFM) defines funds designed with alternative investment schemes for professional investors and not included in UCITS. This category includes a lot of kinds of funds, among them institutional funds. EU regulator defined also European Venture Capital Funds (EuVECA) which pool money to invest in early stage company or in start-ups, European Social Entrepreneurship funds (EuSEF) characterized by investment in positive social impact rather than maximize profits and European Long-Term Investment Funds (ELTIF) that focus investment in infrastructures, real assets and enterprises. The funds described above are characterized by incentives and concessions from government. Other kinds of fund are oriented to undertake leverage to meet operational requirement or apply very different trading strategies in listed or not listed securities. This huge subcategory of AIFM contains Private equity funds and Hedge funds.

An important and further distinction between investment funds is between open-end and closed-end funds. This difference is about the way in which the fund issue and retire shares. An Open-end fund issue new share every time that there is an investor that add cash to the fund, and on the other side retire share when the investor wants to liquidate his shares. This kind of fund is priced one time per day, and usually at the end of trading day. This kind of share management represent most of investment funds even if it is exposed to withdrawals risk if underperform in a short run<sup>148</sup>, but on the other hand this structure seems to solve agency problem. Closed-end funds issue a static number of share available to be traded on an exchange. It raises capital through an IPO with a fix number of shares which are indexed to the interest in portfolios typically focus on specific markets or industry sector. Supply and demand of the investors determine the value of the fund, so market fluctuation can influence the performance of funds in an unlinked way respect to the performance of the assets.

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<sup>146</sup> EU Commission, Consultation on cross-border distribution of investment funds, 2016, [https://ec.europa.eu/info/business-economy-euro/growth-and-investment/investment-funds\\_it](https://ec.europa.eu/info/business-economy-euro/growth-and-investment/investment-funds_it)

<sup>147</sup> Art 1 (2) (b), Directive 2009/65/EC

<sup>148</sup> J.C. STEIN, why are most funds open-end? Competition and the limits of arbitrage, QUARTERLY JOURNAL OF ECONOMICS page 267

Types of funds in the market are well diversified and can satisfy different requirements of the investors, but the main characteristic that the client have to keep in mind is that the fund is managed by the manager which takes decision about the investment strategy of the fund. Managers decide in which securities invests, the goal of the fund, the risk profile, the degree of diversification the timing of investment and all the aspects that regard to the going concern of the fund. The choice of the fund in which invest shall be weighted over different characteristic like strategy, market and general risk. A professional investor, which is aware to different aspects of markets and consequent potential strategies have to investigate more technical factor of funds respect to a retailer. Considering only about the strategies that could be chosen by the manager there are so many possibilities that is difficult for a retailer understand the way in which money are invested.

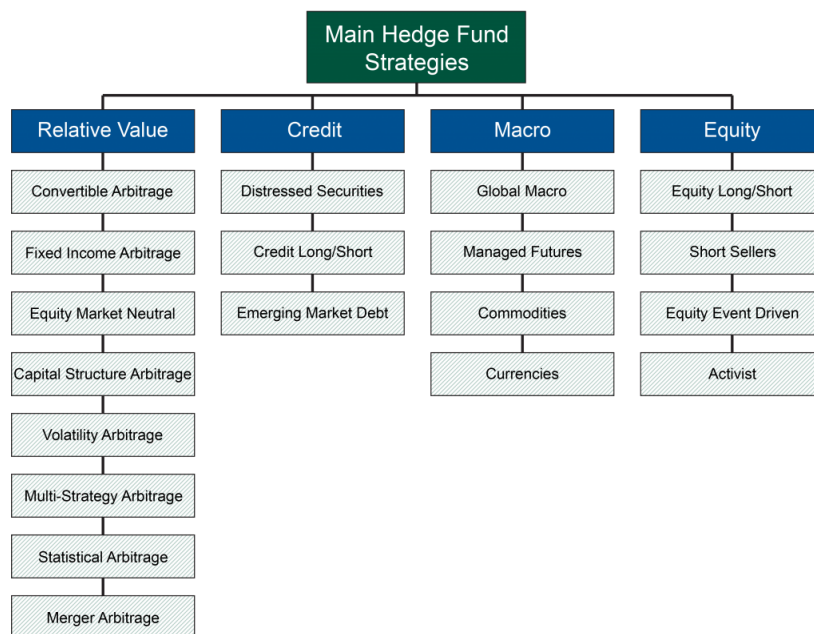


Figure 2. <sup>149</sup>: the degree of complexity which characterized the strategies of a hedge fund.

UCITS distinction is relevant for the application of a different transparency policy with respect to PRIIPs, in fact KIID is a specific tool, used for UCITS and it is designed in directive 2009/65/EC. This format anticipated KID and explain to clients the essential characteristics of the UCITS, providing information in concise manner oriented to inform in direct and simple way the investor. It shall specify how is possible to obtain further information about the UCITS.

<sup>149</sup>Image took by pavilioncorp.com, Classification performed by Pavilion.

### 2.1.2 Insurance-Based Investment Products

Insurance-Based Investment Products are characterized by a binary nature since they include an insurance coverage against biometrics risk alongside an investment element. In this way a single product includes different needs of the customer, this kind of security is designed for those clients that are looking for Investment chance and Insurance coverage at the same time. The main aspect to respect for an insurance-based investment product is the link, direct or indirect, with the market fluctuation. Thus, it is not relevant if the investor is directly or indirectly exposed to risk of capital loss. The categories included are traditional capital life insurance, hybrid products and unit-linked life insurance. The investment part of product is integrated in the insurance policy, in this way part of the costs of the product are referred to investment and other, called premium, to insurance. The insurance part of the product offers different benefits like for example income protection that allow to maintain a given life standard even if the consumer is no abler to work due to any impossibility contained in the contract, either temporary or permanent. Other benefits are: protection of surviving dependents, succession planning and long-term care; all these kinds of benefits are exclusive of insurance-based products and basically it is the element of distinction respect to another investment product<sup>150</sup>. Anyway, the nature of the insurance shall be approved in Art 2 of Directive 1286/2014. This article essentially excludes non-life insurance, pension product for income in retirement as primary purpose and life insurance contract which do not allow to retire the premium before death or before the diagnosis of the illness that determine the incapacity.

The ratio of legislator is to maintain the nature of investment opportunity also for an insurance product, including in insurance-based investment product, only products which allow to investor to participate to profit through a reduction of maturity. These products have the characteristic to cover the biometric risk, and at the same time allow to the investors the use of options to participate to profit, under the rules of the contract.

The insurance benefits derived by these kinds of products are covered by higher cost with respect to other investments. The costs are separated in investment costs and on the other side insurance premium. The investment cost is the amount of money that is invested on the market and it is necessary for all types of investment in regulated market, insurance premium is a payment designated to cover the insurance benefit attached to the product. This cost structure could confuse the investor since he or she can perceive a higher cost respect a comparable investment not linked to insurance product. By the way premium shall never be represented as

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<sup>150</sup> O. FABRY, A. CIUNGU, *insurance-based investment products benefits*, Insurance Europe

a cost because it reflects an additional benefit required by the client and not a pure cost of the investment. This particular structure of the product implies a problem of transparency, in fact the client is not able to comprehend the cost's structure and thus he or she is not in a fair position to compare insurance-based investment with other types of investment. This transparency problem shall be disclosed by advisor in order to achieve a correct representation of costs, if not the investors are misled and so discouraged to invest in investment product which at the same time cover biometric risk only because perceived as more expensive.

This line of thinking is reflected also in KID<sup>151</sup> that represents insurance premium in a separate section respect to the one dedicated to the cost of products, so clients identify clearly different cost of the product and can compare different scenarios of investment. The clear distinction of cost and premium allow to assess different combination of investment, providing to client the possibility to compare traditional investment product, insurance-based investment product and traditional insurance.

### **2.1.3 Retail Structured Deposits**

Structured products are designed by a pre-set formulas or algorithm which calculate returns and loss, in this way the manufacturer built an investment product with a return linked to one or more underlying assets or to markets fluctuation<sup>152</sup>. Retail structured products can take many forms, and they include the most complex product available in the market. This category of product is manufactured to satisfy highly customized risk-return objective but are available also relative simple product. The base form of a structured product does not present a high degree of complexity, it is designed with a traditional investment product and substituting usual payment features with a payoff linked to performance of one or more underlying assets or indexes. Payoffs of structured product can be considered contingent and strictly linked to model of option pricing. However structured products can contain also other more complex derivatives such as swap, forwards and futures, as well as more exotic products that includes leverage upside participations or downside buffers. Investor has to be aware that a higher degree of complexity in which is structured the return of the product correspond to a higher fee for the seller, even if the cost is contained in total price of operation.

A risk common to all structured securities is a relative lack of liquidity respect other products due to two structural factors; first is the impossibility to realize the return of performance before

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<sup>151</sup> See chapter 3 and Appendix 1

<sup>152</sup> Definition of retail structured product, Financial times, [ft.com/lexicon](http://ft.com/lexicon)

maturity for some categories of structured product and the second is the customized nature of product. Investors prefer to hold these instruments till maturity given the low degree of liquidity, so these instruments are recognized such as “held to maturity” investment decision rather than a product used to undertake speculative strategies. To improve the liquidity of structured products Barclays Bank in 2006 introduced Exchange-Traded Notes (ETNs), it’s structured to be similar to ETFs the main difference is that ETNs are Debt instrument with the cash flow linked to underlying asset’s performance. The advantage consists in a higher liquidity since it is traded like a common stock in the exchange and the possibility to access particular exposure that otherwise will be difficult to reach. Structured product can be differentiated in products that provide a capital protection for the investors and other which sacrifice the protection to achieve higher potential return. Product without capital protection can incorporate the risk to lose the principal<sup>153</sup> or part of it. This problem is similar to the risk involved with options, but for this product there is not a uniform pricing standard model and so there is a weak transparency of pricing. The majority of issuer compute the price of structured products with own option models which can allow to hide to client costs and fee structure<sup>154</sup>. The traditional structured products in the example is composed by a bond with zero coupon that ensure stability to the investment, and the second component is a call option on an equity instrument like a ETF or a stock. The initial investment of client corresponds to the value at maturity of bond, so the investment in this case is guarantee, by the way the risky part is represented by the option which in this case have a downside value of zero and a upside value linked to the performance of the underlying during the period of investment.

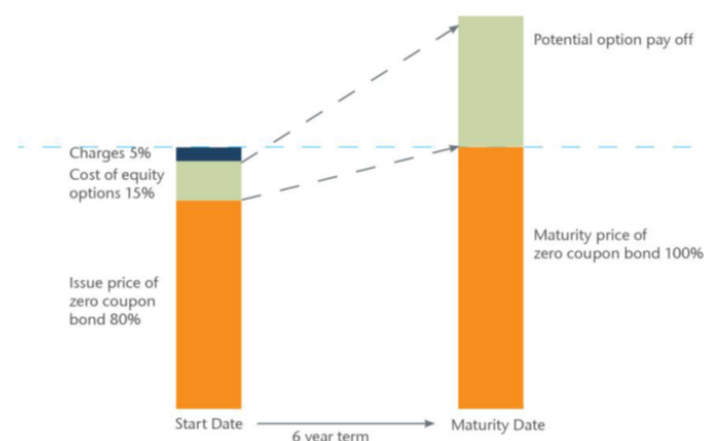


Figure 2. 2<sup>155</sup>: example of a retail structured securities with capital protection.

<sup>153</sup> “amount of money that someone has invested in a bank or lent to a person or organization so that they will receive interest on it from the bank, person, or organization” Cambridge dictionary.

<sup>154</sup> Settlement between Deutsche Bank and the Department of Justice give us a clear example of misleading information about the pricing of RMBS.

<sup>155</sup> METEOR, A guide to retail structured products, 2016

For this product the principal is fully protected, it means that after six years the client will get back at least the amount of initial investment, independently to the fluctuation of underlying asset of option. The only loss of investor is the potential gain that the investor could be earned investing the sum corresponding to option price in other safer investment. This type of protection is designed in a simple way but are available in the market also more complex structure protection

Investor's preferences could be oriented to greater exposure in upside performance and so could be interested in turn down a part, or whole capital protections to risk more capital. This sacrifice of protection paves the way to the possibility to achieve higher performance than a structured product with principal protection. The mechanism that allows higher return is quite intuitive, if an investor bet on an underlying asset with a positive return can receive the double of the return with a cap for the gain, but participate to loss one-to-one for the downside, so there is not principal protection.

The possible negative impact of performances on capital shall be added to the initial cost of investment, so the investor can potentially lose all the amount invested. Usually products are structured in such a way that the capital exposed to loss is settled at the starting point of the investment.

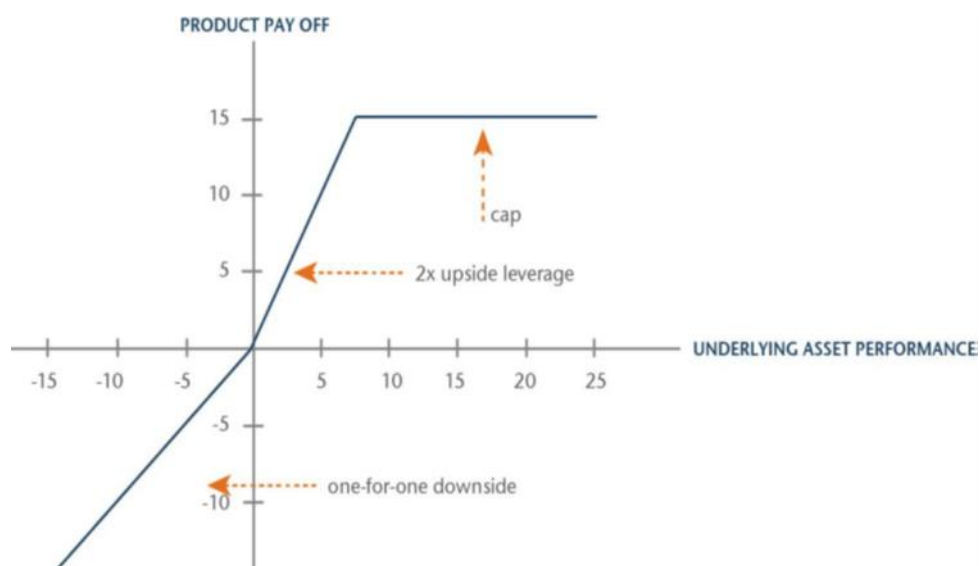


Figure 2.3<sup>156</sup>: example of a retail structured securities without capital protection.

Structured securities became popular in Europe and reached also a good share of market in USA, because they were offered as SEC-registered products, it is a certification for products

<sup>156</sup>METEOR, A guide to retail structured products, 2016

available for retail investors such as stocks, bonds, ETF's and mutual funds. This success in the market initially was due to the fact that structured securities allow customized exposures that otherwise would be difficult to reach, and so structured products became one of the main complement to traditional components of diversified portfolios. The successful entrance in the market of this product's category allows to financial industry to exploit one more channel to raise funds. The investment industry typically built these products based on investor demands, but it started to build products in order to exploit a better-informed position with respect to the client<sup>157</sup>. Manufacturers operates especially with more complex product such as the infamous Collateralized Debt Obligations.

CDOs were one of the main factor in the crisis of 2008, these obligations had a return linked to payoffs of a single ABS or a portfolio of ABS. The complex structure of this product allows to the manufacturer to hide low rating products in pools of higher rated products misleading the customer that bought this product trusting the seller<sup>158</sup>. During the crisis this product, sustained by a more complex structure<sup>159</sup> fraud not only retail client but also professional investors. This reflect the degree of complexity of structured products which can deceive also the evaluations of a professional investor that should be able to understand in which underlying he is investing and so the risk he or she is taking. Since these kinds of product played a main role in the financial crisis is important to understand the errors of the past. The aim of regulator shall be to increase the efficiencies of the market through transparency and a more responsible use of these instrument which can represent an important source for investors.

## 2.1.4 Structured Term Deposit

Structured term deposit is a product that wrapped together a standard deposit and an investment product, the remuneration of structured term deposit shall be paid at maturity. The deposit can be exposed to different kind of investment such as interest rate, premiums or under different risk profile according to<sup>160</sup>:

- Index or combination of indices, not considering variable rate linked to other interest rate
- Financial instrument or combination of financial instrument
- Commodities, other physical or non-physical and non-fungible asset

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<sup>157</sup> See Predatory Landing, page 14

<sup>158</sup> See 1.2.2) Impact of financial crisis page 9

<sup>159</sup> Securitization process described at page 13

<sup>160</sup> Art 4 Directive 2014/65/EU

- Foreign exchange rate or combination of rates

The duration of these products can vary from some months to years. The initial investment in the product is guaranteed till a certain amount by the contract but is not covered by Deposit insurance scheme<sup>161</sup>. The return of the deposit is guarantee whether the investor held to maturity, if not the amount shall be discounted. Principal's guarantee and eventual returns is linked to the creditworthiness of bank as a standard deposit. The risky part of the investment is incorporated by the variable return of the underlying asset. This structure is defined to ensure that the initial lump sum investment will be returned at the end of the investment's period and at the same time achieve returns higher than standard deposits.

The lower level of risk is compensated by the lower potential gain, in fact investors in some cases will not receive the full benefit of all indexes included in the investment part of the product. Different contracts can define the limits of the return through a pre-agreed part of return or a given percentage. The structure of the exposure part of the product can assume a complex scheme and so customers may be confused about the way in which the amount of money is invested.

Anyway, the structure of the product is oriented to guarantee that, independently from limited performance of the exchange market, the client will get back the amount of money initially invested. For example, a structured deposit completely dependent by an underlying asset and the return of this asset can be subject to some limits such as a cap that limits the payable amount of return or a so-called participation rate that can limit the percentage of participation to the underlying asset or index in order to reduce proportionally also the return. Whether an investment of € 100.000 has a cap of 15% and the return at maturity is for example 20% the investor will gain only €15.000 and not € 20.000. On the other side under participation constraint of 50% the return is computed on the participated capital and so for the above example with a return of 20% the investor gains only 10%, which correspond to € 10.000. In this example even if the return is limited by the bundle settled in the contract the investor takes less risk. The characteristics of deposit do not allow an immediate evaluation and to withdraw the deposit before the maturity is necessary wait some days<sup>162</sup>.

The coverage of the initial investment could be redundant but it's an important aspect because help to build trust between the market and the retail investor, that is an aspect weakened in the last years due to recent financial crisis. Moreover, the guarantee of the initial investment helps

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<sup>161</sup> "deposit guarantee schemes in Europe are organized at national level, although minimum standards have been agreed at EU level. Under EU rules, €100,000 per depositor is guaranteed through such schemes" ECB definition.

<sup>162</sup> Chapter 3 shows how is exposed to client different characteristics of products



customer to differentiate structured product by structured term deposit. In fact, for a structured term deposit the principal is guarantee any time that the investor withdraws at maturity, on the other hand structured products do not guarantee every time the return of initial investment.

## 2.2. Drawback of PRIIPs

### *Complexity of products*

PRIIPs description shows that this category of products includes a wide range of securities with different goals and natures, but which respect common characteristics. The main structure of products follows traditional investment products already present in the market; the aspect hard to understand is the way in which the return of the product is determined. The formulas settled by the manufacturer of the product can assume a high degree of complexity since the return can be linked to a chain composed by different underlings; which in turns, participate to the return of the main product in different participation size and percentage of return. These products can be indexed themselves to the return of other products, building a more complex chain to disclose. This complexity increases in an exponential way when more products are packaged together, defining an investment tough to understand also for a professional investor. PRIIPs become trickier in correspondence of an increasing number of underlying assets which built the multiples layers of indexation. Moreover, the sophistication of the formula which links the products to the market fluctuation plays a crucial role in the comprehensibility of the product. Whether indexation formula changes for every link of the chain the effective source of the investment return is hard to disclose. The intricacy of PRIIPs already favored the exploitation of asymmetric information scenarios by investment firms, and the securitization process is a clear example<sup>163</sup>. On the other hand, it is fair to consider that complex formulas are used to satisfy clients, in fact they allow to build personalized returns which are not possible to achieve with traditional products. The benefit for the investors are clear but at the same time complexity of product shall be under the supervision of the authorities. PRIIPs characteristics amplifies the different level of awareness of the client and the investment firm; thus, to avoid the post crisis scenario, the legislator has to implement an effective transparency, learning by the errors of the past. PRIIPs are not subject only to problems derived from complexity but have to face also problems and risk which affect the whole financial market. The return of products is defined by the underlying asset, that for PRIIPs is more complicated to disclose due to the indexation process described above. The fact that is complicated understand which is the underlying asset

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<sup>163</sup> See Securitization, page 16

of the product and the way in which is linked to the final return do not exclude that the product is affected by common risk of financial market. The risk of a PRIIP is not belonging to different nature respect other product, it is only more difficult analyze all the chain that define the ratio between return and risk of the investment. Factors which affect the market impact on the value of underlying asset defining positive or negative fluctuation.

### *Risks involved*

The environment of the financial market is itself a source of risk, the problem is not limited to generic risk but includes also a lot of specific risks. These two risks influence the market in different way. Generic risk is a so called “systematic risk”, it is not possible to diversify and it is represented by fluctuations derived by macro factors’ effect, such as recessions, natural disasters or political disorders that affects performance of overall financial market. About specific risks, it is meant a risk that affect only a defined number of assets, like for example a single firm, a group of company or a specific economic sector. Specific risk is diversifiable and can be divided in Business risk, that is referred to efficiency of the business cycle, and Financial risk that relates with the financial structure of the company. Risks are classified also by nature, one of these, is Liquidity risk which play an important role in the Market. Liquidity is defined by European Central Bank as “the ability of an economic agent to exchange his or her existing wealth for goods and service or for other asset”<sup>164</sup> by this definition is clear that liquidity is linked to the marketability of a product. Obviously, this risk has a direct impact also for PRIIPs in general since are products with a complex structure and is not easy for a retailer know the best moment to divest maximizing the potential return. Asymmetries in information contributes to hinder the efficiency of the market and also Liquidity risk. Furthermore, market is affected by Credit risk, which is represented by the probability of loss due to the borrower’s failure to pay back a contractual obligation or a loan. This risk is widely spread in the market and can be potentially associated to every transaction in a direct or indirect way. In fact, especially for PRIIPs this risk could be indirectly hold by the retail investor since the cash flow of the product is indexed to the performance of another security that is affected by credit risk. Different risks can affect the same product, for example a product with performance is linked to the cash flow of a mortgage is exposed first to credit risk if the borrower is not able to repay the credit. Secondly if the borrower default lender has the possibility to sell the collateral in the market and at this point occur the liquidity risk. Liquidity risk can affect directly also the PRIIP if the holder of the product wants to trade it in the market. The multiple exposures to risks is an

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<sup>164</sup> K. NIKOLAU, Liquidity risk concept definition and interactions, WORKING PAPER SERIES, ECB, 2009 page 10

important aspect, the legislator took it into account for the determination of new measure of product's risk<sup>165</sup>.

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<sup>165</sup> See section 3.3.4 Summary Risk Indicator, page 68



### 3. Key Information Document

#### *Collocation of Kid respect other regulations*

The new form of product description introduced with Regulation 1286/2014, which innovates the disclosure process of the product. The investor, before the introduction of KID, took as benchmark the prospectus to understand the structure and characteristics of product. In particular, “final terms”, which is the part that contain the core of the product, is a schematic and technical definition. The difference between the new form of transparency, and the old one is observable in the Appendix 1 and 2. The previous form of transparency is still in force, but it is not the main tool used to understand the features of financial product, in fact prospectus is more oriented to the registration of the product in financial market and final terms have the role to define the core of the product. The needs of a new tool for the investor protection is given by the impossibility to overcome the transparency paradox<sup>166</sup> with the tools settled by legislator till that moment. The KID is also a way to uniform<sup>167</sup> rules of transparency for all Packaged Retail Insurance-Based Investment Product and at the same time pursue the objective of rebuilding the confidence of retail investors in the financial market<sup>168</sup>. The regulation which designed the KID is applicable to all products defined as PRIIPs, and so exposed to the fluctuation or performance of assets on the financial market<sup>169</sup>. The Regulation 1286/2014 is complementary<sup>170</sup> to MIFID II and to Directive 2002/92/EC<sup>171</sup>, excluding insurance product which do not carry out investment opportunities. The regulation establishes also the relation with other obligation defined by other legislative act in term of transparency and investor protection, confirming that the prospectus designed by Directive 2003/71/EC and Directive 20019/138/EC are still in force and continue to be applied alongside PRIIPs Regulation<sup>172</sup>. Member States as for Prospectus have to set an authority for the supervision of KIDs’ compliance, the authority shall verify the content of KID to ensure that the document is in line with the regulation and that the investors’ protection is ensured in the financial market. The information contained in KID shall be in line with the general principles settled in MIFID II; thus, the information shall be fair, clear accurate and not misleading for the individual. PRIIPs Regulation<sup>173</sup> is implemented by Regulation 2017/653 which set technical standards for the

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<sup>166</sup> See chapter 4:

<sup>167</sup> Recital (4) Regulation 1286/2014

<sup>168</sup> Recital (2) Regulation 1286/2014

<sup>169</sup> Recital (6) Regulation 1286/2014

<sup>170</sup> Recital (5) Regulation 1286/2014

<sup>171</sup> Not in force from 30/9/2018, directive which regulate the insurance product.

<sup>172</sup> Recital (9) Regulation 1286/2014

<sup>173</sup> Regulation 1286/2014

content of KID. The aim of this regulation is the implementation of transparency and is not focused on the introduction of a new passport for the sale of PRIIPs to clients. Moreover, the legislator doesn't want to modify the responsibilities between existing authorities of Member States under the passport arrangements, maintaining the powers of the authority valid also for marketing supervision of product<sup>174</sup>.

UCITS are financial products which enter in the categories regulated by PRIIPs regulation, however, a more recent directive<sup>175</sup> established the use of another tool for UCITS' transparency, called Key Investors Information Document<sup>176</sup>. This misalignment between KID and KIID shall be solved with a period of transition of 5 years after the entry in force of this regulation, which took place in 1<sup>st</sup> January 2018<sup>177</sup>. During this period UCITS will be regulated by KIID and so will not be subject to this regulation, but at the end of the transitional period and in absence of other regulations UCITS are going to be regulated under PRIIPs Regulation.

A review of PRIIPs Regulation is already settled after four years from the date of entry in force<sup>178</sup>; the legislator decided to be prepared for a further future modification of regulation. The objective is to be ready to face new problems such as new types of PRIIPs, future development of financial market or developments in Member States of the union<sup>179</sup>. At this date the legislator shall assess also the possibility to introduce the difference between social and environmental investments, evaluating if the transition period referred to KIID shall be extended or not and whether the introduction of KID had a positive effect on the comparability and understanding of the product. The review includes a survey which concern the availability of calculator for aggregate costs and fees of PRIIPs.

### 3.1. Form and Content

Key information document is a disclosure document which shall be draw up by the manufacturer of the PRIIP before the availability of the product on the market<sup>180</sup>. KID is designed to protect the investors during the relation with the advisor, increasing the effective transparency of the product and so the awareness of the investor with respect to the investment. The Document shall be designed following the main guidelines, content in Regulation

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<sup>174</sup> Recital (24) Regulation 1286/2014

<sup>175</sup> Directive 2009/65/EC

<sup>176</sup> See page 34

<sup>177</sup> Art 18 Regulation 2017/653/EU

<sup>178</sup> January 2018

<sup>179</sup> Recital (36) Regulation 1286/2014

<sup>180</sup> Art 5 (1) Regulation 1286/2014

1286/2014 and the tighter technical standard defined in Regulation 2017/653. The analysis will involve in a first moment the main principles of KID, which determined the main structure of the document, and secondly technical standard to appreciate the way in which the legislator implements the details that characterized KID.

The Key Information Document is part of pre-contractual information and is an obligation for investment advisor provide it to investor before the sign of the contract. It shall follow the principles of accuracy, fairness and clarity to do not mislead the client during the assessment operation. Being a link between the client and the product, the document shall be coherent with the terms and condition of the PRIIPs<sup>181</sup>. KID is thought to be a standalone document, anyway it can contain reference to other informative document defined by EU, but only if the reference is strictly linked to an information that shall be included<sup>182</sup> in KID. For example, kid could contain some cross-reference to Prospectus to clarify some step or to give the possibility to clients to obtain further information. By the way all the required information must be content in KID and cross reference have not to affect the unique nature of the document. On the other side, is not allowed references to marketing material, in fact KID must be completely separated from this kind of information because could influence the consistency and the transparency of the document<sup>183</sup>. In contrast with Prospectus, KID has a pre-settled length, it shall be written in a briefly manner in a maximum of three sides of A4 sized paper<sup>184</sup>, the legislator defines three principles that a KID must respect; it shall be:

- Easy to read, and presented with readable character
- Focused on key information needed by retail investors
- Written with clear succinct and comprehensible

The format of the document can contain colors, whether they are used shall not prejudice the clearance and completeness of the document printed in white and black<sup>185</sup>. The use of manufacturer's logo or corporate brand is allowed inside limits. It shall not cover or obscure the text or distract the attention of client from the information contained in the KID<sup>186</sup>. The language used shall be comprehensible for the client which have to disclose the characteristics of the product, so the legislator obliges to use the official language used in the Member State where the product is sold<sup>187</sup>. Whether the document is not available in the language required, it

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<sup>181</sup> Art 6 (1) Regulation 1286/2014

<sup>182</sup> Settled by the Regulation 1286/2014

<sup>183</sup> Art 6 (2) Regulation 1286/2014

<sup>184</sup> Art 6 (4) Regulation 1286/2014

<sup>185</sup> Art 6 (5) Regulation 1286/2014

<sup>186</sup> Art 6 (6) Regulation 1286/2014

<sup>187</sup> Art 7 (1) Regulation 1286/2014

shall be translated in accurately and closely way, reporting the content of the original KID. In the first page of the document must be written at the top “*Key Information Document*” and shall be directly following by the explanatory statement:

*“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, risk, costs, potential gains and losses of this product and help you to compare it with other products.”*<sup>188</sup>

In this briefly description the legislator wants to be sure that the client understands the scope of the document, and that it is laid down following law defined by legislator and thus oriented to help the investors. First, it is specified that the document contains only the key information of the product and so do not show all the information but only what is considered crucial by the legislator. The target of the document is the transparency, and it is specified also through the citation of the main fields that the document wants to explain and disclose to the investor. The explanatory statement concludes with an important insight for the customer; in fact, communicate that the underlying document is not useful only to understand the single product but also to compare it with other PRIIPs. The content of KID is divided in subsection to achieve a schematic layout of the document<sup>189</sup>:

- General information section
- What is the product?
- What are the risk and what could I get in return?
- What happen if the Manufacturer is not able to pay out?
- What are the cost?
- How long should I hold it, and can I take money out early?
- How can I complain?
- Other relevant information

This scheme is settled to standardized KIDs and provide a logic scheme to the assessment of the investment. KID mix the rigid and precise template in which it is structured with general principles settled in Art 6 (4)<sup>190</sup>. The information contained in these sections constitutes the core of the KID and shall be closely based on the requirements of Regulation 1286/2014 and Regulation 2017/653 to not affect the validity of KID. Marketing information which contain a description of PRIIP shall not include contradiction of KID or reduce the importance of KID.

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<sup>188</sup> Art 8 (2) Regulation 1286/2014

<sup>189</sup> Designed before in Directive 1286/2014 and confirmed in technical standard Regulation 2017/653

<sup>190</sup> See Appendix 1



Moreover, marketing communication must show the presence of KID and the channels from which it can be obtained, included the manufacturer's website<sup>191</sup>. The information contained in KID shall be object of review by the manufacturer and whether the review highlight that need a change in the document the manufacturer shall revise the KID<sup>192</sup>. In Appendix 1 is possible to appreciate a real KID to link all the information to a tangible example.

### *General information section*

This section relates with the Manufacturer of PRIIPs and the competent authority designated by Member State. General information section shall contain the name which the PRIIPs' manufacturer assigned to the product, and if available the International Securities Identification Number of the KID (ISIN) or the Unique Product Identifier<sup>193</sup>. The legal name of the manufacturer shall be followed by the address of website and any useful information to enter in contact with PRIIPs manufacturer also through telephone number<sup>194</sup>. The section shall content also the name of competent authority for the supervision of KID, the date of production of the document and a notice, if it has been revised, of the date last revision. These general data about the manufacturer and the supervisor authority help the client in the identification of the subjects involved in the investment, provide in an effective way useful channels of communication. The section shall present the phrase: "*you are about to purchase a product that is not simple and may be difficult to understand*"<sup>195</sup> to alert investor whether the PRIIPs is considered too complex by the law<sup>196</sup>.

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<sup>191</sup> Art 9 Regulation 1286/2014

<sup>192</sup> Art 10 Regulation 1286/2014

<sup>193</sup> Art 1 (a) Regulation 2017/653

<sup>194</sup> Art 1 (c) Regulation 2017/653

<sup>195</sup> Art 8 (3) (b) Regulation 1286/2014

<sup>196</sup> This sentence results mandatory in case the "*product is an insurance-based investment product which does not meet the requirements laid down in Article 30(3)(a) of Directive (EU) 2016/97 of the European Parliament and of the Council*" or if "*it is a PRIIP which does not meet the requirements laid down in points (i)-(vi) of Article 25(4)(a) of Directive 2014/65/EU of the European Parliament and of the Council*". As defined in Art 1 Regulation 2017/653.

### 3.2. What is the Product?

This section defines the main characteristics and the nature of the PRIIPs specifying the type of product and legal form<sup>197</sup>. The aim of this section is to define the objectives of the PRIIP and the means used to achieve the objective settled, which shall be described in a synthetic, easy and clear way. The type of exposure used to achieve the objective shall be specified whether it is direct or indirect, with respect to the underlying asset. Thus, the factors which influence the return of PRIIPs shall be identified with the underlying asset or reference value. In particular, must be defined how the return is determined and the relation between the return of product and the underlying<sup>198</sup>. In case that the underlying is referred to a multiple number of assets or references values and at the same time, KID cannot content a specific description for each one, shall be described by KID only the types of instrument or the market segment at which they belong<sup>199</sup>.

The profile's description of suitable retail client shall be provided at the end of this section, in this way the manufacturer sets the main features that shall be respected by the client that purchase the product. In a sense, the manufacture at the moment of the creation of the product already know the type of client at which the PRIIP is intended to be sold. This type of consideration on the "target retail client" depends on needs, characteristics and different investment objectives of clients. The evaluation of the manufacturer is based on: the ability to bear losses, technical knowledge, investment horizon and previous experience on the market. Since that the manufacture is the agent that better know the product, the legislator established that it shall identify in KID the type of client for which the product is marketed<sup>200</sup>.

PRIIPs that contain or offer insurance benefits shall be supported by details which clarify all the aspects and conditions of the insurance part of the investment. The "key features of the insurance contract" is the name of the summary that defines benefits of insurance, but the manufacturer shall specify through an explanatory statement that benefit's value are reported in another appropriate section of KID called "*what are the risk and what I could get in return*". In the section "what is the product?" the manufacturer has to includes all the information about the characteristic of biometric risk of retail client. It must show the overall premium of the PRIIP and the part of biometric risk premium that constitute the overall premium. Subsequently shall be shown the impact, at the end of the recommended holding period, of the biometric risk

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<sup>197</sup> Art 8 (3) (c) (i) Regulation 1286/2014

<sup>198</sup> Art 2 (2) Regulation 2017/653

<sup>199</sup> In Appendix 1 the product performances are linked to different shares, these share are briefly described and it is not provided a specific description

<sup>200</sup> Art 2 (3) Regulation 2017/653

premium on investment return. Vice versa can be alternative shown the impact of the cost part of the biometric risk premium compared to recurring costs<sup>201</sup> which are reported in “Cost over timetable”<sup>202</sup>. The amount of premium paid in single a lump-sum form shall match with the information which report the initial amount invested. Whether the premium paid is of periodic nature the manufacturer shall report the number of periodic payments, an estimation of average amount invested and finally the estimated percentage of biometric risk premium with respect to annual premium.

The term of the PRIIP, if known, shall be stated in this section providing the following information<sup>203</sup>:

- Maturity date of PRIIP or eventual absence of it
- Indication whether and when the manufacturer is allowed to terminate the PRIIP unilaterally
- The possible circumstances under which the PRIIP terminate in automatic way and if know the termination dates.

### **3.3. What are the Risks and What Could I Get in Return?**

After the description of the product, the legislator focuses his attention on a crucial step of the KID, the risk-reward profile. The section shall contain a summary risk indicator (SRI) supplemented by description of the indicator, including limitation and eventually aspects that are not captured in an effective way by the SRI<sup>204</sup>. The description that sustain SRI shall mention that whether a PRIIP is evaluated in a foreign currency, with respect to the currency of the country in which is marketed, the final return will be affected not only by the core risk of PRIIP but also by the currency fluctuations<sup>205</sup>. The description has to alert the client that the risk indicated by SRI is referred to investments which last for the whole recommended holding period or until the maturity of the product. Whether the investor decides to not hold till maturity or for recommended period could run a higher risk with respect to SRI<sup>206</sup>. Information about the maximum amount of loss possible and the possibility to lose the investment in absence of adequate protection shall be included, in particular whether<sup>207</sup>:

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<sup>201</sup> Art 2 (4) Regulation 2017/653

<sup>202</sup> Which shall be calculated in accordance with Annex VII of Regulation 2017/653

<sup>203</sup> Art 2 (5) Regulation 2017/653

<sup>204</sup> Art 8 (3) (d) (i) Regulation 1286/2014

<sup>205</sup> Art 3 (2) (c) Regulation 2017/653

<sup>206</sup> Art 3 (2) (d) Regulation 2017/653

<sup>207</sup> Art 8 (3) (d) (ii) Regulation 1286/2014

- The investor risks to lose the entire invested capital
- There is the risk of additional financial commitments, such as liabilities in addition to capital invested
- capital protection is included against market risk, specifying timing of application

In case of early exit penalty for PRIIP the details are shown in paragraph “*how long should I hold it and can I take money out early.*”<sup>208</sup>

These data are reported to support and complete the information contained in SRI, which is one of the main character of KID. It summarizes the risk level of the PRIIP with a numerical indicator, based on a scale from 1 to 7. The indicator is obtained with the aggregation of Market Risk Measure (MRM) and the Credit Risk Measure (CRM)<sup>209</sup>. Furthermore this section shall illustrate the performance scenarios of the PRIIP, assisted by the assumption made, information on return’s condition and eventual impact of tax legislation<sup>210</sup>.

### 3.3.1. Market Risk Assessment

Market risk is measured with volatility of PRIIP on annualized base, it is computed with the Value-at-Risk (VaR)<sup>211</sup> with a confidence interval of 97.5% over the recommended holding period. The annualized volatility of PRIIPs is known as VaR-equivalent Volatility (VEV) but it is not computed in the same way for all PRIIPs, whose are divided in four categories<sup>212</sup> for the purpose of market risk measurement:

- Category 1 includes the riskier products such as the PRIIP that are priced less than monthly base. Are included also PRIIPs have not an appropriate proxy or benchmark or it is priced on less regular basis than monthly. This category involves products which following the market fluctuation could lose the entire or more than entire amount of the investment. This section of product is composed also by Financial contract for difference, Derivatives for transfer of credit risk, Options, Futures, Swap and Forward<sup>213</sup>.

<sup>208</sup> Art 3 (2) (e) Regulation 2017/653

<sup>209</sup> Annex II Regulation 2017/653

<sup>210</sup> Art 8 (d) (III, IV, V) Regulation 1286/2014

<sup>211</sup> “Largest loss likely to be suffered on an investment or portfolio position over a holding period with a given probability, determined by the confidence interval used in the computation.” Definition reported by Business Dictionar.

<sup>212</sup> Annex II, Part 1 (3), Regulation 2017/653

<sup>213</sup> Defined in Annex I, Section C, items 4 to 10 of MIFID II

- Category 2 contain PRIIPs that offer to the investor a non-leverage exposure to the prices of underlying or a leverage exposure on underlying which allow to receive a constant multiple of the price of underlying asset. The exposure can be directly or based on synthetic basis. Are admitted in this category only products with a documented historical price. The product shall present 2 years of daily prices, in alternative 4 years of weekly price or in the worst case 5 years of monthly prices. The category accepts also benchmark or proxy which satisfy required length and frequency of historical prices<sup>214</sup>.
- Category 3 covers PRIIPs that are indexed at the value of an underlying asset but with a formula different from the constant multiple of the underlying. As for category number 2 are required historical prices, thus the PRIIPs shall present 2 years of daily prices, in alternative 4 years of weekly price or in the worst case 5 years of monthly prices. The category accepts also benchmark or proxy which satisfy required length and frequency of historical prices<sup>215</sup>.
- Category 4 include PRIIPs with a value influenced by factors that are not directly observed in the market<sup>216</sup>, covering also the insurance-based product.

In case that the manufacturer presents proxies or benchmarks, in substitution of historical prices, they shall illustrate the asset or the fluctuations which determined the performance of the product. Moreover, proxies and benchmarks shall be supported by the documentation referred to this alternative instrument. The classification of PRIIPs in these four categories is aimed to compute the MRM in different ways for different categories.

MRM for Category 1 has not a formula that calculate the annualized volatility, but MRM is assigned by default. Whether the PRIIP belong to this category only because it is priced with irregularly base, less regular than monthly or it isn't available appropriate proxy or benchmark the MRM class assigned is equal to 6. All the other products shall be classified with a MRM class of 7, which is the riskiest.

The MRM class for Category 2 is computed taking in consideration the observed distribution of PRIIPs' returns for the computation of Value at Risk. The returns shall be computed<sup>217</sup>, over the minimum frequency of observation available, defining over each period the natural logarithm of ratio between price at the end of current period and price at the end of the previous

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<sup>214</sup> Annex II, Part 1 (5), Regulation 2017/653

<sup>215</sup> Annex II, Part 1 (6), Regulation 2017/653

<sup>216</sup> Annex II, Part 1 (7), Regulation 2017/653

<sup>217</sup> Annex II, Part 1 (12), Regulation 2017/653

period<sup>218</sup>. These data are used to build a distribution of returns ( $r_i$ ) used to compute measured moments of the distribution from which are calculated volatility<sup>219</sup>, skew<sup>220</sup> and kurtosis<sup>221</sup> that are the measures needed for the calculus of VaR. The formula given is derived by the Cornish-Fisher Expansion. It is an alternative approach to calculate VaR and fill the inefficiencies of classical method for distributions that are not Gaussian, converging with usual parametric VaR for Gaussian distribution.

The VaR measure in return space is computed as follows:

$$VaR_{(Return\ space)} = \sigma\sqrt{N} * \left( -1,96 + 0,474 * \frac{\mu_1}{\sqrt{N}} - 0,0687 * \frac{\mu_2}{N} + 0,146 * \frac{\mu_1^2}{N} \right) - 0,5\sigma^2 N$$

N: number of trading period in the recommended holding period

$\mu_1$ : skew measured from return distribution

$\mu_2$ : kurtosis measured from return distribution

$\sigma$ : volatility measured from return distribution

Values used to calculate volatility, skew and kurtosis are computed with the moments measured in the distribution with the following criteria:

- Moment zero  $M_0$ : count of the number of observations in the observation period
- Moment first  $M_1$ : mean of all return in the sample
- Moment n:  $\sum_i (r_i - M_1)^n / M_0$

The value of VaR return space shall be used to calculate the VEV which is given by:

$$VEV = \left[ \sqrt{(3,842 - 2 * VaR_{(Return\ space)} - 1,96)} \right] / \sqrt{T}$$

The outcome of this formula shall be associated to values contained in Table 3 to establish the value of MRM which correspond to the PRIIPs. Whether the data used for the calculation of VEV are based on monthly base the class assigned shall be enhanced by one additional MRM class.

There is an exception for PRIIPs that are under management oriented to pursue certain reward objectives, participating through flexible investment strategies or policies in different assets

<sup>218</sup> Prices refereed to the moment of the market close.

<sup>219</sup> "it is the degree of variation of a series over time"

<sup>220</sup> "it is a measure of distortion and represent the asymmetry of the probability distribution random variables about its means"

<sup>221</sup> "it measures the distance of the distribution from the normal distribution"

classes. PRIIPs under this niche of Category 2 shall use the VEV with the higher values within the following<sup>222</sup>:

1. VEV calculated in accordance with method of Category 2
2. VEV of pro-forma asset mix, consistent, at the time of computation, with the reference asset allocation
3. VEV consistent with the risk limit of the fund

In case of variation of strategy during the observation period of returns the VEV used shall be the higher between 2 and 3<sup>223</sup>.

PRIIPs in Category 3 have to take in consideration, as value for the calculation of Value at Risk, the distribution of PRIIPs' price at the end of the holding period. Since the future data can't be available at the moment of the assessment the manufacturer shall obtain the distribution with simulations of PRIIPs' price. The VaR value must be computed with an interval of confidence of 97.5% at the end of the recommended holding period. The value obtained shall be discounted to present at the expected free-risk discount factor<sup>224</sup>. The minimum number of simulation is 10000<sup>225</sup>, the simulation shall be performed on bootstrapping<sup>226</sup> the expected distribution of price levels for underlying assets from the distribution of returns. The variables observed by the manufacture can be spot prices or curves. The use of spot price or curves imply two different methodology of simulations required by the legislator. Whether PRIIP, which belong to this category, is characterized by unconditional capital protection it is not required a simulation. The Value at Risk is calculated discounting the amount guaranteed by capital protection, at the expected free-risk discount factor, calculated at the end of recommended holding period.

Category 4 includes PRIIPs with performance of part of performance linked to unobservable factors or under the control of PRIIP's manufacturer. The VaR for this kind of product shall be assessed in the following way. The PRIIPs components shall be identified and associated to other Categories of PRIIPs if possible<sup>227</sup>, on the other side, whether is not possible associate the component to other classes it shall be evaluated as wholly dependent from unobserved factor. For each component that is associated to a PRIIPs' class the VEV shall be computed following the method indicated by legislator. Components which depends wholly from unobserved factors shall follow a robust and well recognized industry to estimate the future contribution of this

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<sup>222</sup> Annex II, Part 1 (14) (a), Regulation 2017/653

<sup>223</sup> Annex II, Part 1 (14) (b), Regulation 2017/653

<sup>224</sup> Annex II, Part 1 (16), Regulation 2017/653

<sup>225</sup> Annex II, Part 1 (19), Regulation 2017/653

<sup>226</sup> "bootstrap method is a resampling technique used to estimate statistics on a population by sampling a dataset with replacement", J. BROWNLEE, Statistical method, 2018.

<sup>227</sup> Annex II, Part 1 (26), Regulation 2017/653

factor. This method is focused on the estimation of a relevant expectations if possible, whether is not possible link the component to a well-recognized industry shall be used a bootstrap methodology set out for the computation of VEV in Category 3. The VEV for PRIIPs component will be the combination of Bootstrap methodology and well-defined industry. The final value of VEV for these products shall be a weighted average to define the overall VEV in a proportional way. In case of unconditional protection of capital, the VaR is computed discounting the amount of capital protected, at the end of recommended holding period, using the risk-free discount factor expected, maintaining the confidence interval at the constant level of 97,5%<sup>228</sup>.

MRM Class	VaR-equivalent volatility (VEV)
1	< 0,5
2	0,5% - 5,0%
3	5,0% - 12%
4	12% - 20%
5	20% - 30%
6	30% - 80%
7	> 80%

*Table 3. 1: Conversion of VEV in MRM class, it describes the corresponding MRM class of a PRIIP for a given level of VEV<sup>229</sup>*

### 3.3.2. Credit Risk Assessment

Credit Risk play a role whether PRIIPs, its underlying assets or exposures are influenced by the creditworthiness of manufacturer or other agents that are bounded to perform payments to the investors, in a direct or indirect way. The entity which shall make the payment to the investor for a PRIIP is identified as the “direct obligor”, and the assessment of credit risk shall be performed on this entity. When payment obligations are guaranteed by an agent different from the direct obligor, identified as “guarantor”, the credit risk assessment of guarantor can substitute the assessment of the direct obligor. The guarantor shall cover unconditionally and irrevocably the obligation or obligations, if not can’t substitute the credit assessment of direct obligor<sup>230</sup>. Credit risk assessment required a look-through basis and a cascade assessment of

<sup>228</sup> Annex II, Part 1 (29), Regulation 2017/653

<sup>229</sup> Annex II, Part 1 (2), Regulation 2017/653

<sup>230</sup> Annex II, Part 2 (32), Regulation 2017/653



credit whether PRIIPs is structured with exposure to credit risk of PRIIP itself and underlying investments which contain further exposures to credit risk<sup>231</sup>. On the other side if the exposure to credit risk is referred only to underlying asset and not to PRIIP itself the credit risk shall be assessed at the level of underlying. PRIIPs could contain also multiple underlying asset that entailed exposure to Credit Risk, in this case the exposures which exceed the 10% of total asset shall be assessed with a separate procedure. For underlying or exposures which concern derivatives, exchange traded or OTC, no credit risk shall be considered whether the exposure is fully and appropriately collateralized or the exposure do not exceed 10% of total assets amount<sup>232</sup>.

The manufacturer of the PRIIP shall define an External Credit Assessment Institutions (ECAI)<sup>233</sup> with the aim to have an independent and consistent evaluation of credit risk. It is possible that are available multiple ways to assess a credit risk according to that policy, in that case shall be considered the median rating or the lower one between the two middle values. The Credit Risk of the PRIIP shall be based on:

- PRIIP' s credit assessment assigned by ECAI
- Credit assessment of relevant obligor performed by ECAI
- In absence of credit assessment of PRIIP or obligor shall be performed a default credit assessment<sup>234</sup>.

The output of the evaluation is a number from 0 to 6, where the higher value indicates a lower creditworthiness and thus a higher credit risk. In case of an assessment equal to 7 for the MRM is not necessary evaluate the credit risk<sup>235</sup>.

### *Credit Quality Steps*

The allocation of credit steps is given by the translation of credit risk rating assessed by ECAI in number. The typical rating is expressed in letter with a codified language that can assume different facets for different ECAI. The legislator defines Credit Quality Step in order to uniform different rating codex under the same scale and do it with the Regulation 2016/1800<sup>236</sup>.

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<sup>231</sup> Annex II, Part 2 (33), Regulation 2017/653

<sup>232</sup> Annex II, Part 2 (36), Regulation 2017/653

<sup>233</sup> Registered with ESMA

<sup>234</sup> Described in the following section "credit quality step"

<sup>235</sup> Annex II, Part 2 (30), Regulation 2017/653

<sup>236</sup> Conversion's standards provided in Appendix 5

Table 3. 2: Conversion of credit rating of an ECAI in Credit Quality Step, in the example ARC Rating SA<sup>237</sup>

Credit Quality Step	0	1	2	3	4	5	6
Long-term Debt Rating	aaa	aa+, aa, aa-	a+,a,a-	bbb+,bbb, bbb-	bb+, bb, bb-	b+,b, b-	ccc+, ccc, ccc-

The assessment with a look-through imply a conversion in credit quality step weighted on the average of credit quality step of any obligor considered relevant. Whether the evaluation involve a cascade method all the exposures must be assessed in separate way per each layer, assigning the highest credit quality step. The credit quality step obtained by the assessment of the ECAI shall be adjusted by the manufacturer considering the maturity or recommended holding period of the PRIIP.

Credit Quality Step	Adjusted Credit quality Step , with recommended holding period up to 1 year	Adjusted Credit quality Step , with recommended holding period in the range between 1 and 12 years	Adjusted Credit quality Step , with recommended holding period over 12 years
0	0	0	0
1	1	1	1
2	1	2	2
3	2	3	3
4	3	4	5
5	4	5	6
6	6	6	6

Table 3. 3: conversion standard of Credit quality step in Adjusted Credit quality steps based on different recommended holding periods<sup>238</sup>.

In absence of external credit assessment, the evaluation shall be implemented through the *default credit assessment*<sup>239</sup> which evaluate with credit quality step 3 obligor regulated by insurance undertaking under union law and credit institution. Step 3 is given also to obligors which are domiciled in a Member State with credit quality step 3. All the other cases are rated as credit quality step 5<sup>240</sup>.

<sup>237</sup> Annex Regulation 2016/1800

<sup>238</sup> Annex II, Part 2 (42), Regulation 2017/653

<sup>239</sup> See page 65

<sup>240</sup> Annex II, Part 2 (43), Regulation 2017/653

*Credit Risk Measurement*

When the credit quality step is adjusted to recommended holding period or maturity it shall be converted in CRM. This rating scale is from 1 to 6 and convert the credit quality step equal to 0 in 1, anyway, this is not the only change is required by the conversion in CRM. Whenever the credit right of the retail investor is subordinated to the claim of the senior layer of creditor the CRM conversion shall be increased by 2 classes with respect to the equivalent adjusted credit step quality<sup>241</sup>. The conversion states 3 classes of penalties for PRIIPs that are part of the own funds of the obligor of PRIIP<sup>242</sup>.

*Table 3. 4: Conversion of Adjusted credit quality steps in CRM<sup>243</sup>:*

Adjusted Credit Quality Step	CRM
0	1
1	1
2	2
3	3
4	4
5	5
6	6

There are some mitigation factors about the characteristic of PRIIP asset or collateral, which influence the assessment of CRM. In fact, may be assigned a CRM 1 to the PRIIP with an asset or appropriate collateral that respect following condition:

- Value equivalent to the payment obligation at all times until maturity
- Held with a third party on a segregated account under equivalent terms
- Not accessible to any other creditor of the manufacturer

The CRM assigned to the PRIIP is of level 2 whether the asset or appropriate collateral are:

- Value equivalent to the payment obligation at all times until maturity
- Identified and held on account or registers<sup>244</sup>

<sup>241</sup> Annex II, Part 2 (50), Regulation 2017/653

<sup>242</sup> As defined in Art 4(1) (118) of Regulation (EU) 575/2013 of the European Parliament and of the Council.

<sup>243</sup> Annex II, Part 2 (45), Regulation 2017/653

<sup>244</sup> including Articles 275 and 276 of Directive 2009/138/EC of the European Parliament and of the Council

- The right of claim of the of investor have priority respect to other creditor of manufacturer

### 3.3.3. Liquidity Risk

PRIIPs are considered under relevant liquidity risk in case that fulfill either of the subsequent condition:

- PRIIP admitted to the secondary market but not guaranteed by a market maker, so liquidity depends on availability of demand or supply on the market.
- Average profile of liquidity of investment is lower than regular payment frequency of PRIIP.
- Manufacturer forecast difficulties for retail investor about the possibility to divest during the life-cycle of the product.

The manufacturer has to advise the investor also in case of liquidity problem, which are not admitted to trading on a secondary market, or it is subject to limiting condition for liquidity facility such as discretionary redemption price and exit penalties<sup>245</sup>. In the others cases the PRIIP is considered liquid, by the way the liquidity risk is not computed and used to estimate SRI, it is only notified the presence to the client.

### 3.3.4. Summary Risk Indicator

The SRI take place from the aggregation of market risk measurement (MRM) and credit risk measurement (CRM) and is assigned to the PRIIP in accordance with the following table.

The manufacturer shall monitor market data relevant to the computation of MRM, evaluating variation in the market factors which affect the MRM. Whenever it is found a variation the manufacturer shall attribute the corresponding MRM to the PRIIP<sup>246</sup>. Moreover, the review of MRM shall be performed every time that the manufacturer takes a decision about investment policy or strategy<sup>247</sup>. The constant monitoring shall be performed also for the credit risk criteria

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<sup>245</sup> Annex II, Part 3 (57), Regulation 2017/653

<sup>246</sup> Annex II, Part 3 (53), Regulation 2017/653

<sup>247</sup> Annex II, Part 3 (55), Regulation 2017/653

which affect the computation of CRM, whether there is a variation the manufacturer shall re-compute the CRM class and so the overall SRI.

CRM class \ MRM class	MR1	MR2	MR3	MR4	MR5	MR6	MR7
CR1	1	2	3	4	5	6	7
CR2	1	2	3	4	5	6	7
CR3	3	3	3	4	5	6	7
CR4	5	5	5	5	5	6	7
CR5	5	5	5	5	5	6	7
CR6	6	6	6	6	6	6	7

Table 3. 5<sup>248</sup>: Aggregation process of CRM and MRM to synthesize Summary Risk Indicator.

### Presentation of SRI

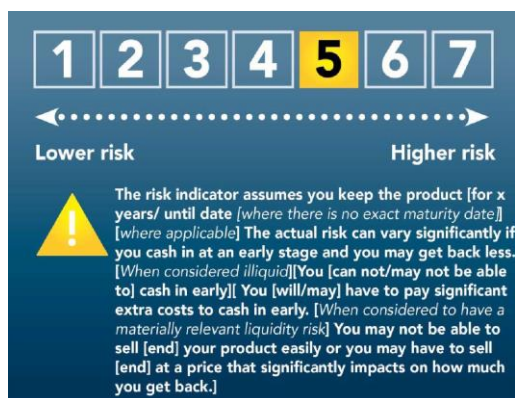


Figure 3. 1<sup>249</sup>: Template to expose the SRI in KID.

The SRI shall be presented using the pre-settled format in order to be standardized for each KID, the SRI referred to the PRIIP shall be highlighted, taking also in consideration that it shall be understandable even if printed in black and white<sup>250</sup>.

The presentation of SRI shall be supported by a general explanation with narrative purpose immediately below the SRI. First it is indicated that: *The summary risk indicator is a guide to*

<sup>248</sup> Annex II, Part 3 (52), Regulation 2017/653

<sup>249</sup> Annex III (1) Regulation 2017/653

<sup>250</sup> Annex III (1) Regulation 2017/653

*the level of risk of this product compared to other products. It shows how likely it is that the product will lose money because of movements in the markets or because we are not able to pay you*<sup>251</sup>. Explanation shall contain the recommended holding period and the possibility to run a higher risk in case of a holding period different from recommended. Whether the PRIIP incur in a relevant liquidity risk or to be illiquid under the SRI presentation shall be included a special warning. In the description of SRI shall be specified in bold characters if the PRIIP hold the obligation to add the initial investment or carry out a currency risk<sup>252</sup>. In this section the manufacturer shall specify the capital protection of the PRIIP if it hold it, describing:

- Partial or total capital protection, including specification of percentage
- Specific condition which limits the capital protection
- No capital protection on market risk<sup>253</sup>
- No capital guarantee against credit risk<sup>254</sup>

PRIIP which are offering a range of investment options with different risk classes, the manufacturer shall show all different levels of risk from the lower to the higher. Options and futures exchanged on regulated market, or an equivalent market, shall show only information which concerns their characteristic, summarized in general description<sup>255</sup> and SRI indicator including if necessary the specification about the absence of capital protection against market risk.

### **3.3.5. Performance Scenarios**

After the presentation of SRI which shall give an insight about the risk level that the investors are running, allowing also to compare it with other PRIIP, the manufacturer shall show a range of possible scenarios of return. The legislator set four main scenarios<sup>256</sup>:

1. Favorable scenario
2. Moderate scenario
3. Unfavorable scenario
4. Stress scenario

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<sup>251</sup> Annex III (7) Element A Regulation 2017/653

<sup>252</sup> Annex III (4)(a) Regulation 2017/653

<sup>253</sup> In case the manufacturer shall indicate “*This product does not include any protection from future market performance so you could lose some or all of your investment*”. Annex III (7) Element H Regulation 2017/653.

<sup>254</sup> In case the manufacturer shall indicate “*If (we) (are) not able to pay you what is owed, you could lose your entire investment*”. Annex III (7) Element H Regulation 2017/653.

<sup>255</sup> Annex III (7) Element A Regulation 2017/653

<sup>256</sup> Annex IV (1) Regulation 2017/653

Moreover, for insurance-based investment product is required an additional scenario based on the parameter of Moderate scenario.

The different scenarios are calculated in similar manner and shall be computed over the recommended holding period. The value represented in different scenarios represents the value of PRIIP at different percentiles. The favorable scenario is PRIIP's value at 90<sup>th</sup> percentile, Moderate scenario at 50<sup>th</sup> percentile and unfavorable at 10<sup>th</sup> percentile<sup>257</sup>. The calculus takes in consideration the different reference value for different categories of PRIIP, settled for the computation of VEV in market risk measurement (MRM). The stress scenario takes in consideration different aspects for the computation and so each category has a specific methodology to compute the value, the details for the computation of Category 2 is contained in points 10 and 11 of Annex IV on the other side stress scenario for Category 3 is settled in points in 13 and 14 of Annex IV. *"The performance of the PRIIP shall be calculated net of all applicable costs in accordance with Annex VI<sup>258</sup> for the scenario and holding period being presented"*<sup>259</sup> to highlight the effective performance of the instrument. Performance must be available in monetary units and in percentage form, the computation of percentage shall be made with the ratio between net performance and initial investment amount<sup>260</sup>. For the insurance-based product shall be took in consideration the future profit participation which shall derive from consistent assumption in line with the annual rate of return of underlying assets. The assumption about the division and sharing of profits participation between investor and manufacturer shall be aligned with the business strategy and practices of manufacturer<sup>261</sup>. The components of payment that are receivables only in discretionary basis shall be added to the value of PRIIP only in case of Favorable performance scenarios.

#### *Presentation of Performance Scenario*

The presentation of performance scenario shall respect the principles of fairness, accuracy, clearance in order to do not mislead the average retail investor during the process of investment's assessment<sup>262</sup>. Scenarios presented are referred to the recommended holding period as defined in previous section. Category 1 of PRIIP shall respect specific standard for

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<sup>257</sup> Annex IV (4,5,6,7) Regulation 2017/653

<sup>258</sup> Annex referred to Regulation 2017/653

<sup>259</sup> Annex IV (31) Regulation 2017/653

<sup>260</sup> Annex IV (33) Regulation 2017/653

<sup>261</sup> Annex IV (34) (c) Regulation 2017/653

<sup>262</sup> Annex V Part 1 (1) Regulation 2017/653

the presentation of scenarios. The template used for the presentation of scenarios shall respect the format established by legislator<sup>263</sup>.

The table shows the amount of money that the investor could get back in future, considering different scenarios in which money are invested in Euro. The aim of the performance scenario is to reflect the way in which the PRIIP could perform. The standardized representation is oriented to allow the comparison among different products, helping the retail client in the assessment. The scenarios are estimation based on past performance, however, the indicators reported in the scenarios shall not considered as exact future values but more as a representation of what the investor will receive based on different market fluctuation.

### Performance Scenarios

Investment EUR 10'000		
Scenarios		1 year (recommended holding period)
<b>Stress scenario</b>	<b>What you might get back after costs</b> Average return each year	<b>EUR 1'572.23</b> -84.28% p.a.
<b>Unfavourable scenario</b>	<b>What you might get back after costs</b> Average return each year	<b>EUR 7'654.65</b> -23.45% p.a.
<b>Moderate scenario</b>	<b>What you might get back after costs</b> Average return each year	<b>EUR 10'794.84</b> 7.95% p.a.
<b>Favourable scenario</b>	<b>What you might get back after costs</b> Average return each year	<b>EUR 10'794.84</b> 7.95% p.a.

Figure 3. 2: Example of performance scenarios took by Appendix 1

It is important specify that the stress scenario, which represent the worst scenario, doesn't consider the scenario in which the obligor is not able to repay. When is applicable the presentation of an intermediate holding period, the investor shall consider that the product could be not easy to cash in especially before the end of recommended holding period. Thus, the estimation of the value of the PRIIP could be not perfect due to the presence of higher costs. The cost shown in the performance scenarios are about all the cost that are sustained for the product itself; anyway, the performance scenario may not show all the costs that the investors have to sustain for the services provided by the financial advisor of the distributor<sup>264</sup>. Moreover, the tax situation of the investor is not considered, since it is subjective for each client, but could have an impact over the final return of the investment.

<sup>263</sup> Annex V Part 2 Regulation 2017/653

<sup>264</sup> Annex V Part 2 Element F Regulation 2017/653



For PRIIPs of Category 1 that are options or futures traded on regulated market<sup>265</sup> the performance scenarios are represented in different form with respect to other PRIIPs, in fact it is shown through a graph. The graph presents a range of possible outcomes, so it is far to provide an exact indication of the return. The return is linked to the underlying' performance and for each value that could assumes the underlying the graph show the corresponding profit or loss profile. The horizontal axis represents the prices of underlying value on the expiry date while the vertical axis represents the payout. The performance scenario shall specify that the maximum loss is equal to the whole amount invested, corresponding to the premium paid. The explication of performance scenarios with the use of the graph exclude the representation of all costs referred to tax situation, distributor and investment advisor; and includes only costs of product itself<sup>266</sup>.

### 3.4. Other Sections

*What happens if the manufacturer of PRIIP is unable to pay out?*

The section describes in a concise manner whether, in case of loss due to inability to pay of the manufacturer, the loss is covered by a guarantee or a compensation scheme. Eventually the scheme shall be specified including the name of the guarantor and the linked risks covered by the scheme and also the risks that are not covered.

*What are the costs?*

The costs associated to the investment could be direct or indirect, one-off and recurring, and shall presented by means of an indicator of costs<sup>267</sup>. It includes the total aggregate costs expressed in monetary and percentage terms to ensure the comparability. Furthermore, the KID shall specify that advisors, distributor, any other intermediary, or seller of the PRIIP will provide detailed information describing any cost of the distribution not included in the indicator described above. In this way the intermediary provides enough information to the investor, enabling him to comprehend the total effect of aggregate on return. The role of advisor is not to provide the total costs but allow to the retailer to understand the cumulative effect of cost<sup>268</sup>.

*How long should I hold it and can I take money out early?*

The manufacturer shall show not only the recommended holding period but also the minimum required holding period. Eventual cooling-off period or cancellation period for the PRIIP must

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<sup>265</sup> Annex IV (17) Regulation 2017/653

<sup>266</sup> Annex V , Element K, Regulation 2017/653

<sup>267</sup> Art 8 (3) (f) Regulation 1286/2014

<sup>268</sup> See Appendix 4

be reported in this section, with all the applicable fees and penalties which regard risk and reward profile<sup>269</sup>.

#### *How can I complain? and Other relevant information*

These two sections constitute the conclusive part of the KID and inform the client about the ways in which can make a compliant about the product, the advisor or any other agents involved in the transaction. Other information about the pre-contractual and post-contractual stage are contained only whether necessary.

### **3.5. Provision of KID**

The person advising on or selling a PRIIP shall provide to the retailer the KID in the pre-contractual stage, in a moment considered in good time before that the investor is bounded by a contract or an offer relating to a PRIIP<sup>270</sup>. The KID could be provided to investor after the conclusion of the contract, and so in delay, only if all the following conditions are satisfied<sup>271</sup>:

- The retailer contacts first, and so on own initiative, the seller of PRIIP and conclude the transaction through tools of distance communication.
- The provision of KID is not possible
- The retailer has been informed by the advisor or seller that the KID's provision is not available, and the advisor shall offer the possibility to delay the transaction after the provision of KID
- The retailer accepts to receive the KID in delay, after the conclusion of the contract

The transaction that follows, regarding the same PRIIP of a previous transaction, do not require the provision of KID. The provision of KID shall be free of any charge and can be provided in three media<sup>272</sup>:

1. Paper
2. Durable media other than paper
3. Website

Paper form is the default option for the provision of KID and usually is offered on face-to-face basis, the retailer could also require another form whether preferred. The durable media other than paper is provided in case that it is appropriate in the context of the business conducted and

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<sup>269</sup> Art 8 (3) (g) (iii) Regulation 1286/2014

<sup>270</sup> Art 13 (1) Regulation 1286/2014

<sup>271</sup> Art 13 (1) Regulation 1286/2014

<sup>272</sup> Art 14 (2) Regulation 1286/2014

the retailer choose it in an evidenced way<sup>273</sup>. The provision of KID by means of the website allowed if it is appropriate with the context of the business conducted and the KID remains available on the website for the period in which the retailer may need it. Furthermore, is required an electronic or written notification about the address of website and where the KID can be accessed.

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<sup>273</sup> Art 14 (4) Regulation 1286/2014



## 4 Revolution of Investor's Protection through the KID

### 4.1 Transparency Paradox

Financial products do not exist in nature, like an apple or water, they are a conceptual construction<sup>274</sup> of the manufacturer. In order to understand a PRIIP is necessary identify and analyze the source of the product. Before to proceed with the analysis is important to distinguish two different situations. The definition of the product is a separate moment with respect to the description.

The definition is referred to the process of creation of the product, before the definition the product does not exist. Thus, this process shall be precise and technical since set the "core" of the product. Products are defined in a specific part of Prospectus<sup>275</sup>, and every word used to define the product assumes a high importance because every facet determine a different product. The information are written in relative short document called "final terms"<sup>276</sup>, attached to prospectus and other eventual document of registration to the market<sup>277</sup>. The registration document standard<sup>278</sup> is technical and the information contained define the instrument. It presents data through a schematic layout in order to not let room for misunderstanding in the definition of the product. The information contained in this document are really far from the understandable standard of a retail client<sup>279</sup>. Anyway, the technical nature of the document is necessary for the definition of the product, in fact only highlighting the essential information in a precise way the manufacturer well defines the core of product. Any deviation from the essential content has an impact on the core of the product modifying it in another product. The simplification of the jargon could imply confusion in the essence of products; thus, the process of product's definition shall be rich of meaning but poor of words<sup>280</sup> to satisfy the aim of the process.

On the opposite the description of the product is designated to the comprehension of the product by an investor. It is an important step for the transparency's process since it represents the moment in which the flow of information reaches the investor. The information contained in

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<sup>274</sup> A. LUPOI, Financial products within the scope of law: rising of the financial risk as core component of any financial transaction, RIVISTA TRIMESTRALE DIRITTO ED ECONOMIA, 2017 p 90

<sup>275</sup> A. LUPOI, Financial products within the scope of law: rising of the financial risk as core component of any financial transaction, RIVISTA TRIMESTRALE DIRITTO ED ECONOMIA, 2017, page 24

<sup>276</sup> Directive 2010/73/EU

<sup>277</sup> Any Member state's market has different specific document

<sup>278</sup> Annex 1 Commission Regulation 809/1004 (valuta se allegare)

<sup>279</sup> ANNEX FINAL TERM

<sup>280</sup> A. LUPOI, Financial products within the scope of law: rising of the financial risk as core component of any financial transaction, RIVISTA TRIMESTRALE DIRITTO ED ECONOMIA, 2017, page 94

“final terms” are typically too precise and technical to be understood by retail client. In order to fill this lack of financial education is necessary describe the product using easier and more comprehensible words, which can't be used in the definition of the product. The fact that the client generally has not the knowledge necessary to understand the product is confirmed by the failure of previous<sup>281</sup> transparency form. Prospectus for example, is a tool still in force but it contains a huge amount of information for the client and in some points is really technical and precise. Prospectus is a useful tool for transparency, but it is not suitable for a retail investor, the length<sup>282</sup> and the density of data contained are more suitable for the analysis of a professional investors than a retailer. With respect to “final terms”, prospectus try to describe the essence of the product contained in the final term but in more comprehensible manner. The result is a document which describe the product in a relative easier language, but it clarifies the information defined in six pages by final term in more than 300 pages<sup>283</sup>. The retailer has to face a double barrier, on one hand the information is precise, technical and summarized in a schematic way but not comprehensible due to insufficient financial education. On the other hand, the prospectus contained all the information necessary to evaluate a document, however, the amount of information is too wide to be assessed correctly by the retail client. Information overload<sup>284</sup> do not allow to prospectus to be an effective tool for the aim of legislator since it does not result clear for the retailer, enhancing the problem of transparency efficiency.

The transparency paradox for financial product in general concern the retail client because the information contained in the definition of the product are not understandable by investors due to knowledge's barrier. On the other side the investor is subject to information overload since the description is aimed to explain the product in a comprehensive way reporting too much information that do not allow a fair assessment of the product.

The legislator understood that the retail client can't understand all the detail of a complex investment operation, and it adapted the transparency framework to something that the investor can understand in intuitive way. The pursuit of a new frontier of transparency is stimulated by the necessity to avoid the lack of transparency, which brought to the financial crisis, and at the same time protect the saving of retailer which are the weaker part in the transaction. The new system settled by the legislator, to overcome the transparency paradox, is supported by two main tools: MIFID questionnaire and Key Information Document.

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<sup>281</sup> Respect to KID introduced by MIFID II

<sup>282</sup> See Appendix 2

<sup>283</sup> Compare Appendix 2 and Appendix 3

<sup>284</sup> M.J. EPPLER, J. MENGIS The Concept of Information Overload: A Review of Literature from Organization Science, Accounting, Marketing, MIS, and Related Disciplines, THE INFORMATION SOCIETY 2010, page 326

## 4.2 Centrality of Risk

The “core” of the product, meant as the information contained in “Final Terms”, can't be the object of transparency tools because it can't be described to the client and at the same time the definition of the product can't be modified due to limits described above. The effects of paradox affect negatively the investor's protection because it is the weaker part and, he or she, invests money without knowing the characteristic of the investment. The legislator tries to solve this problem moving the aim of description from the essence of the product to the financial risk of the investment's operation<sup>285</sup>. This implies a conceptual shift in the investment operation logic; in fact, the main aspect is no more the financial product but the financial risk that the investor is taking with a given operation. The product became the tool which host the financial risk of the operation<sup>286</sup>.

The centrality of financial risk is the main renovation designed by MIFID II in the field of investor's protection. The whole framework of investor's protection is based on the pillar of financial risk. Starting from definition of investment advice of MIFID I and recalled by MIFID II the attention of the legislator is not focused on the product but on the “*personal recommendation to client*”<sup>287</sup>. This shift is already oriented to the centrality of client but was not so clear the way in which is designed the personal aspect of advisory. The principles of Appropriateness and Suitability<sup>288</sup> clarifies that the personal nature of the service is the subjective risk profile of the investor. The legislator took risk profile of customer as cornerstone to solve transparency paradox for different motivations.

The *definition* of the product is not a parameter that can be modified to allow an easy comprehension of the product, because as explained before, a variation shall imply a direct impact on the nature of the product. A change in the definition moment shall not allow to solve problems of transparency since it will cause a simplification of financial product. The simplification of the product's core would cause a reduction of possible exposures and performance of financial products, making a step behind with respect to the level of technology available nowadays. Thus, an adjustment of definition's moment does not make sense and it results untouchable for the legislator. The complex nature of the product shall not be modified even if far from the comprehension level of retail clients. The final aim of transparency is to

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<sup>285</sup> A. LUPOI, Financial products within the scope of law: rising of the financial risk as core component of any financial transaction, RIVISTA TRIMESTRALE DIRITTO ED ECONOMIA, 2017, page 97

<sup>286</sup> A. LUPOI, Financial products within the scope of law: rising of the financial risk as core component of any financial transaction, RIVISTA TRIMESTRALE DIRITTO ED ECONOMIA, 2017, page 97

<sup>287</sup> Art 4 Directive 2004/39/EC

<sup>288</sup> See section 1.3) Financial Transparency, page 24

introduce a new disclosure mandate. Disclosure means provide information oriented to prepare people to take complex decisions which can result unfamiliar for them<sup>289</sup>. The description of the product in prospectus failed the disclosure purpose for retail investors. As already described prospectus is not suitable for retail investors, anyway, the problem is not linked only to Prospectus but also to retailer. A survey carried out by British Financial Service Authority<sup>290</sup> observes that the problem is not limited to the complexity of information provided but concern also the fact that peoples do not even read the material provided in pre-contractual stage. The complexity problem of prospectus, peoples' bias that in some cases do not even read information and the distortion of individuals' decisions due to implication of behavioral finance; are clear indexes that the description of the product is not an effective way for the disclosure of financial products. After the failure of product's description, the attention has been moved from the description of product to the comprehension of financial risk.

Initially, financial risk was only an accessory information contained in prospectus which offered sustain to the description of the product. The financial risk described wasn't specific but were reported a lot of useless information about the generic risk of investment<sup>291</sup>. When the turnaround of transparency information took place, with KIID and then KID, it determines the substitution of generic risks with the specific risk of products. These information took the key role in disclosure's process, and the comprehension of financial risk run by investor substitute the description of the product. The description of the product does not coincide with the comprehension of the risk<sup>292</sup>, by the way, a minimum level of information about the product is necessary even if not sufficient for the comprehension of financial risk. The specific risk of the product is linked to multiple aspects<sup>293</sup> but until the introduction of KIID wasn't available a synthetic indicator of risk for the retail investor. Risk's centrality is sustained by the fact that a retailer is more interested to the return of the investment respect to the nature of the product purchased. Therefore, the core of investment operation became the running of a financial risk, finalized to get a return, and not to the purchase of a given financial product. Information are so oriented to disclose this aspect of investment trying to provide useful data to answer at the questions: *What are the risk?* and *What can I get in return?*

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<sup>289</sup> M. SALO, H. HAAPIO, S. PASSERA, Putting Financial Regulation to Work: Using Simplification and Visualization For Consumer Friendly Information, 19th INTERNATIONAL LEGAL INFORMATICS SYMPOSIUM IRIS 2016, page 2

<sup>290</sup> Nowadays Financial Conduct Authority, survey was made in 2003.

<sup>291</sup> A. LUPOI, il tramonto dell'informazione letterale, l'alba dell'informazione numerica? RIVISTA DIRITTO BANCARIO, page 5

<sup>292</sup> A. LUPOI, il tramonto dell'informazione letterale, l'alba dell'informazione numerica? RIVISTA DIRITTO BANCARIO, page 4

<sup>293</sup> See *risks involved*, page 50



Assuming the financial risk as the new core of investment, since it is the representation of personal aspect of the advice activity, shall be considered that now the essential information provide to client concern to risk of the product and not to the type of product offered. Furthermore, being the risk the core of the contract, a non-compliance of the risk profile could involve a claim for the breach of the contract. The SRI became the benchmark for the evaluation of financial investment in PRIIPs for retail investor, this new form of communication renews the transparency process not only for the centrality of risk but also for two main characteristics:

- Numerical Information
- Representation of Specific Risk

This new form of transparency results more synthetic and direct, since it does not require specific knowledge to be understood. The KID changes not only the core information, but also the way in which it is reported. The revolution was anticipated in part by KIID which entered in force in 2011 and settled rules only for UCITS. This document has the same main structure and concepts<sup>294</sup> of KID but the technical standards<sup>295</sup> provided by legislator are less stringent with respect to KID's technical standards. The main differences are about the length, two pages respect the three of KID, and the presence of past scenarios performance which in KID is not included. This document was not analyzed in deeper way since it is not going to be valid after 2023<sup>296</sup> and it regard only a part of the market represented by UCITS. The main function of KIID is a sort of trial which paved the way for the introduction of KID.

### 4.3 Numerical Information and Specific Risk

The information contained in SRI<sup>297</sup> are about the volatility of product's price in the market, which represent the market risk of the product, and the probability of default, that is measured by the credit risk of investment operation. The numerical synthesis of these information allows to investor to understand in easier and more direct way the financial risk of investment operation; which, before the introduction of SRI, was exposed in a complex and misleading descriptions<sup>298</sup>. The information is immediately understood by the investor since the index is represented in the middle of the other values of the scale<sup>299</sup>. In this way the information is not misleading because the context in which it is presented provide the scale of values in which the

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<sup>294</sup> See *Key Investor Information Document*, page 34

<sup>295</sup> Regulation 583/2010

<sup>296</sup> Art 18 Regulation 2017/653/EU

<sup>297</sup> See section 3.3.4 Summary Risk Indicator, page 68

<sup>298</sup> See Chapter 1 and 2

<sup>299</sup> See page 69 Figure 3.1

single product is collocated. Furthermore, the numerical information allows the comparison of different product through the SRI<sup>300</sup>. This kind of information allows to client to understand and compare product which until the introduction of KID were not accessible for retail investor with a low level of financial education. Changing the design of presentation, the legislator changed also the core of the information, overcoming some biases that distorts the transparency of investment operation<sup>301</sup>. The focus of legislator on the visualization and simplification aspects is totally oriented to the overcome of transparency paradox. The introduction on SRI allows to<sup>302</sup>:

- Offer more visible logic and a structure to the document
- Provide immediate overview and insights for the operation
- Clarify what written language does not manage
- Provide alternative access to the product information<sup>303</sup>
- Includes potential investors that were alienated by complex information

The numerical information are not limited to SRI but includes also Performance scenario<sup>304</sup> which help to presents possible returns of investment. Performance scenarios support the SRI, providing the link between risk and possible returns of the investment. The presence of performance scenario allows to represent the risk of the investment in more real terms since are reported potential loss and profit for different scenarios. The investor that does not know the quantitative origin of SRI can understand and compare information anyway if he or she links the SRI to performance scenario in intuitive way. The fairness of indicator is guaranteed by the manufacturer of the product. Performance Scenario complete the numerical information, which results less abstract and more linked to real word. Retail Investors can assess the investment with data focused on the specific risk of the product, providing more precise information with respect to the general risk reported in Prospectus. The numerical information overcome in part the language barrier, for KID released in different Member States. Even if the language differ the numerical info allow to investor to compare the main aspect of products: Risk and Return.

The SRI excludes from the representation a lot of information which are considered redundant and superfluous. For some aspects this fact could be interpreted as a loss of information's

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<sup>300</sup> A. LUPOI, *il tramonto dell'informazione letterale, l'alba dell'informazione numerica?* RIVISTA DIRITTO BANCARIO, page 6

<sup>301</sup> EIOPA, *What will change with KID?*, <https://eiopa.europa.eu/consumer-protection/consumer-lounge/>

<sup>302</sup> M. SALO, H. HAAPIO, S. PASSERA, *Putting Financial Regulation to Work: Using Simplification and Visualization For Consumer Friendly Information*, 19th INTERNATIONAL LEGAL INFORMATICS SYMPOSIUM IRIS 2016

<sup>303</sup> Since the prospectus is still in force, whether an investor prefer to use the Prospectus is free to do it.

<sup>304</sup> See section 3.3.5 Performance Scenario, page 70

completeness but as recalled in transparency paradox and in the consequent failure of Prospectus, it is a necessary sacrifice for the effectiveness of transparency. Anyway the prospectus is a document still in force, so the investors interested to denser and huger amount of data about the investment can consult the Prospectus. The investor shall be aware that also numbers which express the SRI can be misleading. SRIs are indexes of credit and market risk, but it is referred to a specific holding period which can vary for different products; thus, the investor shall be careful in the comparison of different products. Moreover, credit and market risk do not represent all the risk in the market; liquidity and currency risk are excluded by SRI computation but can influence the final return of the investment. The advisor's fee is not included in the KID, since it is composed by Manufacturer, and the investor to evaluate the whole cost of operation shall add this cost to the costs indicated in KID<sup>305</sup>. The SRI results so a good indicator for the risk of the investment; by the way, the retailer shall not incur in the mistake to take in consideration only the SRI for the investment decision. The SRI shall be compared first of all with the risk profile determined in MIFID Questionnaire, and only after the fulfilling of Suitability shall be performed a more specific assessment about the investment. Thus, the main objective of SRI is to provide a guideline easy to follow for the retail investor, which is not able to understand what the risk he or she is taking. Investors shall be aware that the information summarized in KID could be object of further variation after the conclusion of pre-contractual stage<sup>306</sup>. The centrality of risk is an important revolution in the field of investor's protection, the information about the characteristic of the product passed in the background but shall not be forgotten by the investor since can still play a role in the investment decision since SRI do not consider all the risks but only the two main.

#### 4.4 The Investor Protection

The document aimed to protect the investors in the advisory activity are the KID, designed by manufacturer, and the MIFID questionnaire defined by the advisor. These tools are complementary because collect and represent necessary information from two opposite side of investment operation, necessary for the fulfillment of Suitability's principle. KID is oriented to provide information about the product in a more effective and direct way with respect previous form of transparency. The aim is to protect the investor from misleading information which could be provided by advisors<sup>307</sup>, the KID is written by manufacturer also to avoid the

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<sup>305</sup> See section 3.4 Other Sections, page 73 and Appendix 4

<sup>306</sup> See Appendix 1

<sup>307</sup> See section 1.2.2, page 13 and *Securitization*, page 16

possibility that the advisor exploits the conflict of interest writing down misleading KID. When the advisor and the manufacturer are the same entity the legislator try to protect the investor with the new rules about incentives and fees<sup>308</sup>. The source of information of KID is standardized and based on quantitative analysis of past data related to possible future scenarios. The discussion about the methodology implemented for the SRI and the Performance scenario is still open, by the way at nowadays is impossible provide an empirical analysis about correctness of numerical indicator of KID with respect real performance. By the way in future can be interesting analyze, if and when, the insight provided by performance scenarios are respected in real world, and which performance's differences present products with the same SRI. The KID is the tool which was missing to the transparency process, in fact as described above it provide more "democratic" information accessible and understandable by everybody. The degree of protection is higher providing less information, because the KID does not contain all the characteristics of the product, but at the same time is understandable by everybody. The decision of legislator is based especially on retail investor needs; historically this category represent the layer of population which lose more savings and wealth due to lack of effective transparency in financial sector's investment. The KID represents the main tool for the protection of investment, especially in this historical moment, where the European Banking sector in going to face the end of quantitative easing program of ECB and the consequent reduction of bank's liquidity which shall involve the retailer. The role of KID is to ensure protection of investor with the aim to restore the confidence of retail clients.

The blind spot of the investor protection mechanism is represented by the MIFID questionnaire and the consequent definition of investor's risk profile. The new mechanism substitutes the centrality of the product with the centrality of risk, and it bases the intuitive aspect on a single numerical indicator. The fulfillment of suitability principle, which is the cornerstone of new mechanism, is based on the match between risk level of product and risk profile of investment. The profiling of client is the output of MIFID Questionnaire<sup>309</sup>, by the way, different investigations based on descriptive and empirical approach disclose worrying findings. The lack of standardization in questionnaire's structure and content show, in Italy, large differences in term of number of questions and fields investigated<sup>310</sup>. These differences have dramatic effects on the investor protection, since different questionnaires could produce different risk profiles for the same investors, undermining the correct fulfillment of suitability principle. The

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<sup>308</sup> See section 1.2.3 "Renovation of financial advisory through MIFID II and MIFIR, page 20

<sup>309</sup> See section 1.3.1 Context of application, page 28

<sup>310</sup> See "Questionnaire", page 30

empirical part of the analysis<sup>311</sup> show that a sample of 100 potential investors obtain different risk profiles filling different questionnaires. The Legislator shall impose a standardized Questionnaire to ensure the investor's protection; moreover, the questionnaire do not seem oriented to the subjective characteristic of client but anchored to traditional asset allocation strategies<sup>312</sup>. The problem of lack of standardization is followed by the personal nature of information collected in questionnaire which is affected by threats concerning the behavioral finance<sup>313</sup>. The lack of complete rational behavior of individual affect different economic fields and risk compliance is not excluded. These problems shall be solved with a standardized questionnaire which take into consideration the problems implicated by behavioral finance.

This effort of legislator to renovate client's protection field is aimed to reach a basic level of transparency which allows, to retail investor, to understand whether an investment risk is suitable for his or her preferences. The attention about the risk shall increase for investor but also for advisor because with the new legislation the risk is the main object of the advisory activity. The new perspective of investment advisory implies a higher attention in the definition of product's risk for the manufacturer and an enhanced attention in the compliance of new rules and requirements. The new mechanism provides higher standards in the pre-contractual stage, in order to increase the protection of the investors; and at the same time ensure a more effective transparency through information more direct and comprehensible.

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<sup>311</sup> N. MARINELLI, C. MAZZOLI, Profiling investors with the MiFID: current practice and future prospects, Research paper.

<sup>312</sup> N. MARINELLI, C. MAZZOLI, Profiling investors with the MiFID: current practice and future prospects, Research paper, page 15

<sup>313</sup> See "Impacts of Behavioral Finance over MIFID Questionnaire", page 32



## CONCLUSION

The problems outlined by financial crisis obliged the European legislator to renovate the investor protection and to restore the confidence of retail client. After the renovation of investment advisory, the legislator sets a new mechanism for the protection of the retail client. The mechanism requires a match between the risk of the product and the risk profile of the client, in accordance with the fulfillment of suitability's principle.

The dissertation analyzes mainly the flow of information provided by KID and so referred to the description of product's risk and possible returns. This analysis reveals that the new tool improves the protection of the investor respect to unsuitable investment. The centrality of risk and the numerical information help the retailer to be more aware about the basic information to know about the investment operation. The intuitive nature of numerical index makes accessible the information to a wider range of investors, since it does not require a financial knowledge to be understood. Risk's centrality on the other hand allows to overcome the transparency paradox, basing the disclosure process on a more practical and understandable measurement. The characteristics of KID make the information about the investment more comprehensible by the retail investor and so more useful for the disclosure process. The standard provided by the legislator to the manufacturer for the preparation of KID helps to contrast the asymmetric information between advisor and investor. From the point of view of risk profiling of investor, the tool settled by the legislator has some lack. The questionnaire that should evaluate the risk profile is not a standardized instrument and the dynamics of assessment are influenced by a lot of perception's distortion, described by the behavioral finance. These aspects of MIFID questionnaire have a negative impact over the protection of the client since different questionnaires provide different risk profiles for the same investors. This lack has a negative effect over the functioning of the entire mechanism of protection. The legislator should correct the questionnaire to ensure a proper functioning of the new investor's protection mechanism.





# APPENDIX

## APPENDIX 1



### Key Information Document

#### Purpose

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.

#### Product

<b>Product name / ISIN:</b>	<b>Barrier Reverse Convertible with Coupon</b> in EUR linked to several Underlyings (BNP Paribas SA -A- (Share), Crédit Agricole SA (Share), Société Générale SA (Share), each an <b>Underlying</b> and together the <b>Underlyings</b> ), ISIN: CH0366565072 (the <b>Product</b> )
<b>Product Manufacturer:</b>	<b>Credit Suisse AG</b> , our website: <a href="http://www.credit-suisse.com/derivatives">www.credit-suisse.com/derivatives</a> , Call +41 (0)44 335 76 00 for more information.
<b>Issuer:</b>	Credit Suisse AG, Zurich, acting through its London Branch, London UK
<b>Competent regulatory authority:</b>	The relevant authority

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**You are about to purchase a product that is not simple and may be difficult to understand.**

#### What is this Product?

**Type:** Uncertificated securities (Wertrechte) governed by Swiss law.

**Objectives:** The Product is a complex financial instrument linked to several Underlyings (BNP Paribas SA -A- (Share), Crédit Agricole SA (Share), Société Générale SA (Share), each an **Underlying** and together the **Underlyings**, see table below). By investing in the Product, the investor may obtain returns in the form of Coupon Amounts which are not dependent on the performance of the Underlyings. The Coupon Amounts are equal to 8% p.a. of the Denomination and are payable on the Coupon Payment Dates.

If the investor holds the Product until the Final Redemption Date, the maximum amount the investor may receive will be the Final Redemption Amount plus the sum of the Coupon Amounts due on the Coupon Payment Dates. The investor will not participate in any positive performance of the Underlyings.

By investing in the Product, the investor may obtain on the Final Redemption Date a Final Redemption Amount equal to the Denomination provided that the Underlyings perform favourably for the investor. If the Underlyings perform unfavourably for the investor, the Final Redemption Amount may be lower.

In detail:

- If the level of **each** Underlying is **above** its Barrier at all times during the Barrier Observation Period: The Product is redeemed at the Denomination.
- If the level of **at least one** Underlying is **at or below** its Barrier at any time during the Barrier Observation Period **and**
  - If the Final Level of **each** Underlying is **at or above** its Strike: The Product is redeemed at the Denomination; or
  - If the Final Level of **at least one** Underlying is **below** its Strike: The Product is redeemed by delivery of the number of Worst-Performing Underlyings specified in the Ratio of the Worst-Performing Underlying, i.e. the Final Redemption Amount will be linked to the negative performance of the Worst-Performing Underlying. Any remaining fractions will not be delivered, but compensated by a payment in EUR. In such case the Final Redemption Amount will generally be less than the amount you invested.

The risk and reward profile of the Product described above will differ if the Product is sold before the Final Redemption Date.

#### Product data

<b>Issue Price</b>	100% of the Denomination (EUR 1'000)	<b>Issue Date</b>	06.11.2017
<b>Denomination</b>	EUR 1'000	<b>Minimum Trading Lot</b>	EUR 1'000
<b>Initial Level</b>	100% of the closing level of each Underlying on the Initial Fixing Date.	<b>Strike</b>	100% of the Initial Level of each Underlying
<b>Initial Fixing Date</b>	01.11.2017	<b>Ratio</b>	For each Underlying an amount equal to the Denomination divided by its Strike.
<b>Last Trading Date</b>	01.11.2018	<b>Final Redemption Date</b>	06.11.2018
<b>Final Fixing Date</b>	01.11.2018	<b>Final Level</b>	100% of the closing level of each Underlying on the Final Fixing Date.
<b>Worst Performing Underlying</b>	Out of all the Underlyings, the Underlying in respect of which its Final Level divided by its Strike results in the <b>lowest</b> value	<b>Coupon Amount</b>	8% p.a. of the Denomination
<b>Coupon Payment Dates</b>	07.05.2018 and 06.11.2018	<b>Barrier</b>	69% of the Initial Level of each Underlying
<b>Barrier Observation Period</b>	From 02.11.2017 (including) until 01.11.2018 (including)	<b>Product Currency</b>	Euro (EUR)

#### Underlying data

Underlyings	Initial Level
BNP Paribas SA -A- (Share)	EUR 65.95
Crédit Agricole SA (Share)	EUR 14.95
Société Générale SA (Share)	EUR 47.80

**Intended retail investor:** This Product is intended for retail investors, with sufficient knowledge & experience in Structured Products: Participation / Yield Enhancement and

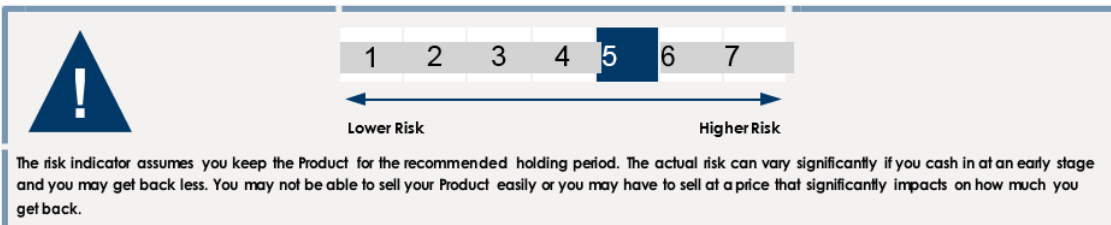
similar products, an average ability to bear investment loss and a short-term investment horizon.

**Term:** The Final Redemption Date of the Product is November 6, 2018. The term of the Product is until the Final Redemption Date. The Product provides that if certain extraordinary events occur, the Issuer may terminate the Product early. These events principally relate to the Product, the Issuer and the Underlyings. The amount you receive on such extraordinary early termination will be different and may be less than the amount you invested.

Any dividend payments made on any of the Underlyings, which is a share or similar equity instrument, will not be distributed to investors.

## What are the risks and what could I get in return?

### Summary Risk Indicator



The summary risk indicator is a guide to the level of risk of this Product compared to other products. It shows how likely it is that the Product will lose money because of movements in the markets or because we are not able to pay you. We have classified this Product as 5 out of 7, which is a medium-high risk class. This rates the potential losses from future performance at a medium-high level, and poor market conditions are very unlikely to impact our capacity to pay you. **Be aware of currency risk** if your reference currency differs from the currency of the Product. You might receive payments in a different currency, so the final return you will get depends on the exchange rate between the two currencies. This risk is not considered in the indicator shown above. This Product does not include any protection from future market performance so you could lose some or all of your investment. In case of redemption of the Product by delivery of a number of Underlyings, you may incur losses from the Final Fixing Date to the date, when the Underlyings are deposited in your account and thereafter. If we are not able to pay you what is owed, you could lose your entire investment return.

### Performance Scenarios

#### Investment EUR 10'000

Scenarios		1 year (recommended holding period)
<b>Stress scenario</b>	<b>What you might get back after costs</b> Average return each year	<b>EUR 1'572.23</b> -84.28% p.a.
<b>Unfavourable scenario</b>	<b>What you might get back after costs</b> Average return each year	<b>EUR 7'654.65</b> -23.45% p.a.
<b>Moderate scenario</b>	<b>What you might get back after costs</b> Average return each year	<b>EUR 10'794.84</b> 7.95% p.a.
<b>Favourable scenario</b>	<b>What you might get back after costs</b> Average return each year	<b>EUR 10'794.84</b> 7.95% p.a.

This table shows the money you could get back over the next 1 year, under different scenarios, assuming that you invest EUR 10'000. The scenarios shown illustrate how your investment could perform. You can compare them with the scenarios of other Products. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and are not an exact indicator. What you get will vary depending on how the market performs and how long you keep the Product. The stress scenario shows what you might get back in extreme market circumstances, and it does not take into account the situation where we are not able to pay you. The figures shown include all costs of the Product itself, but may not include all the costs that you pay to your advisor or distributor. The figures do not take into account your personal tax situation, which may also affect how much you get back.

## What happens if Credit Suisse AG is unable to pay out?

If Credit Suisse AG becomes insolvent, investors should in the worst case be prepared to suffer a total loss of their investment. The Product is not covered by any statutory or other deposit protection scheme. If the issuer and/or the guarantor are subject to any resolution measures (e.g. bail-in), your claim rights may be reduced to zero, converted into equity or its maturity date may be altered.

## What are the costs?

The Reduction in Yield (RIY) shows what impact the total costs you pay will have on the investment return you might get. The total costs take into account one-off, ongoing and incidental costs. The amount shown here is the cumulative costs of the Product itself, for the recommended holding period. It includes potential early exit penalties. The figures assume you invest EUR 10'000. The figures shown are estimates and may change in the future.

### Costs over time

The Person selling you or advising you about this Product may charge you other costs. If so, this person will provide you with information about these costs, and show you the impact that all costs will have on your investment over time.

**Investment EUR 10'000**

Scenarios	If you cash in at the end of the recommended holding period
Total costs	EUR 271.12
Impact on return (RIY) per year	2.71% p.a.

**Composition of costs**

The table below shows:

- the impact each year of the different types of costs on the investment return you might get at the end of the recommended holding period;
- the meaning of the different cost categories.

**This table shows the impact on return per year**

One-off costs	Entry costs	2.71% p.a.	The impact of the costs you pay when entering your investment and the costs already included in the price. This is the most you will pay and you could pay less.
	Exit costs	n/a	The impact of the costs of exiting your investment when it matures.
Ongoing costs	Portfolio transaction costs, other on-going costs	n/a	Ongoing costs do not apply for this Product.
Incidental costs	Performance fees, carried interests	n/a	Incidental costs do not apply for this Product.

**How long should I hold the investment and can I take money out early?****Recommended holding period: 1 year (i.e. until the Final Redemption Date)**

The Product has a term of 1 year. It does not provide for an early termination right of the investor. Therefore, investors should be prepared to stay invested for the term of the Product. The only possibility to cash in the Product earlier is by selling the Product through the exchange where the Product is listed or to the Product Manufacturer/Issuer outside of such exchange. The Product will be listed on the SIX Swiss Exchange. The Product Manufacturer will endeavour to provide bid and offer prices for the Product on each business day under normal market conditions, but is under no legal obligation to do so. A sale of the Product may in particular not be possible under exceptional market circumstances or in case of technical disruptions. An investor selling the Product during the term may potentially only receive sales proceeds below the issue price of the Product.

**How can I complain?**

Any complaint regarding the person who recommended or sold the Product to you can be submitted directly to that person.

Any complaint regarding the Product (terms), this document or the conduct of the Product Manufacturer can be submitted in writing to Credit Suisse AG Cross Asset Derivatives Sales PO Box CH-8070 Zurich, or via e-mail to [structured.products@credit-suisse.com](mailto:structured.products@credit-suisse.com), or visit our website [www.credit-suisse.com/kid](http://www.credit-suisse.com/kid).

**Other relevant information**

This key information document does not contain all information relating to this Product. Please refer to the underlying prospectus for the legally binding terms and conditions of the Product as well as a detailed description of the risks and rewards associated with this Product. The prospectus is available on [www.credit-suisse.com/derivatives](http://www.credit-suisse.com/derivatives), and a paper copy of this document may be obtained free of charge from Credit Suisse AG, Transaction Advisory Group, Uetlibergstrasse 231, 8070 Zurich, Switzerland. The information contained in this key information document does not constitute a recommendation to buy or sell the Product and is no substitute for individual consultation with the investor's bank or advisor. Any updated version of this key information document will be published on: [www.credit-suisse.com/kid](http://www.credit-suisse.com/kid).

## APPENDIX 2

## TERMS AND CONDITIONS

## TERMS AND CONDITIONS OF THE COMPLEX PRODUCTS

The following are the Terms and Conditions of the Complex Products, which will govern the issue of the Complex Products. These Terms and Conditions should be read in conjunction with all other sections of this Document and the Base Prospectus.

A Complex Product does not constitute a collective investment scheme within the meaning of the Swiss Federal Act on Collective Investment Schemes ("CISA"). Therefore, it is not subject to authorisation or supervision by the Swiss Financial Market Supervisory Authority FINMA ("FINMA"). Investors bear the issuer risk. The Complex Products are structured products within the meaning of the CISA.

## Section 1 Definitions and Key Terms

## Section 1.1 Issue Specific Terms, Definitions and Other Information

## A. Issue Details

Name of Product	Barrier Reverse Convertibles on Shares.	
SSPA Product Category	Investment Products, Yield Enhancement, Barrier Reverse Convertible (1230), see SSPA Swiss Derivative Map at <a href="http://www.sspa-association.ch">www.sspa-association.ch</a> .	
Product Features	LastLook:	Not applicable
	Lookback:	Not applicable
	Lock-in:	Not applicable
	Basket Feature:	Not applicable
	Bear Feature:	Not applicable
	Inverse Structure:	Not applicable
	COSI:	Not applicable
	Interest Payment(s):	Applicable
	Issuer Call:	Not applicable
	Payout Payment(s):	Not applicable
	Premium Payment(s):	Applicable
	Trigger Barrier:	Not applicable
	CURINT:	Not applicable
Underlyings	the Shares, as described in subsection D.	
Security Codes	Swiss Sec. No.	36 656 507
	ISIN	CH 036 656 507 2
	Common Code	171 518 563
	SIX Symbol	ABPQCS
Issuer	Credit Suisse AG, Paradeplatz 8, 8001 Zurich, Switzerland, acting through its London Branch, One Cabot Square, London E14 4QJ, United Kingdom Credit Suisse AG London Branch is authorised and regulated by FINMA in Switzerland, authorised by the Prudential Regulation Authority, and subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of the regulation of Credit Suisse AG London Branch by the Prudential Regulation Authority are available from the Issuer on request.	

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Lead Manager	Credit Suisse AG, Paradeplatz 8, 8001 Zurich, Switzerland
Dealer(s)	Credit Suisse AG, Paradeplatz 8, 8001 Zurich, Switzerland
Paying Agent	Credit Suisse AG, Paradeplatz 8, 8001 Zurich, Switzerland, and any agents or other persons acting on behalf of such Paying Agent and any successor appointed by the Issuer.
Calculation Agent	Credit Suisse AG, Paradeplatz 8, 8001 Zurich, Switzerland, and any agents or other persons acting on behalf of such Calculation Agent and any successor appointed by the Issuer.
Listing Agent	Credit Suisse AG, Paradeplatz 8, 8001 Zurich, Switzerland
Expenses/Fees charged by the Issuer to the Holders Post-Issuance	See Section 2.2, 3 <sup>rd</sup> paragraph

Trading (Secondary Market)	Under normal market conditions, Credit Suisse AG, Paradeplatz 8, 8001 Zurich, Switzerland, will endeavour to provide a secondary market, but is under no legal obligation to do so.
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Upon investor demand, Credit Suisse AG, Paradeplatz 8, 8001 Zurich, Switzerland, will endeavour to provide bid-ask prices for the Complex Products, depending on actual market conditions. There will be a price difference between bid and ask prices (spread).

The Complex Products are traded in percentage of the Denomination at a clean price, i.e., the trading price does not contain accrued interest or premium, which is calculated separately, and are booked accordingly.

Indicative trading prices may be obtained on Reuters CSZEO00 and Bloomberg CSZE.

Listing / Admission to Trading	Application will be made to list the Complex Products on the SIX Swiss Exchange Ltd for trading on its platform for structured products. It is expected that the Complex Products will be admitted to trading on the SIX Swiss Exchange Ltd on a provisional basis as of 7 November 2017.
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The Issuer may decide at any time at its sole discretion and without any further consent from the Holders to delist Complex Products listed on the SIX Swiss Exchange by giving notice to the Holders in accordance with Section 9 at least three months prior to the last trading day stating that such Complex Products will be delisted from the SIX Swiss Exchange and no longer traded on SIX Swiss Exchange.

Complex Products that are listed on any regulated market or stock exchange(s) or admitted to trading by a relevant authority may be suspended from trading and/or delisted at any time in accordance with applicable rules and regulations of the relevant regulated market or relevant stock exchange(s).

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Issue Size	up to EUR 10'000'000 (may be increased/decreased at any time)
Denomination	EUR 1'000
Issue Currency	EUR
Issue Price	100% of the Denomination
Subscription Period	until 1 November 2017, 15:00 CET The Issuer reserves the right not to issue the Complex Products without giving any reason. The Issuer further reserves the right to terminate the Subscription Period early.
Issue Date/ Payment Date	6 November 2017, being the date on which the Complex Products are issued and the Issue Price is paid.
Last Trading Date	1 November 2018, until the official close of trading on SIX Swiss Exchange Ltd, being the last date on which the Complex Products may be traded.
Minimum Trading Lot/ Subscription Amount	EUR 1'000
<b>B.</b>	<b>Redemption</b>
<b>B.1</b>	<b>Final Redemption</b>
Final Redemption	Unless previously redeemed, repurchased or cancelled, the Issuer shall redeem each Complex Product on the Final Redemption Date by payment of a cash amount or, subject to Section 2.2, delivery of a number of Underlyings equal to the Final Redemption Amount to the Holder thereof.
Final Redemption Date	6 November 2018, being the date on which each Complex Product will be redeemed at the Final Redemption Amount, unless previously redeemed, repurchased or cancelled.
Final Redemption Amount	(i) If <b>no</b> Barrier Event has occurred, a cash amount equal to 100% of the Denomination; or (ii) If <b>a</b> Barrier Event has occurred, and (a) the Final Level of <b>each</b> Underlying is <b>at or above</b> its Strike, a cash amount equal to 100% of the Denomination; or  (b) the Final Level of <b>at least one</b> Underlying is <b>below</b> its Strike, the number of Worst-Performing Underlyings specified in the Ratio of the Worst-Performing Underlying.
Settlement Type	Physical settlement or cash settlement
Settlement Currency	EUR
Ratio	with respect to each Underlying, the relevant Ratio specified in <b>Table A</b> , being the number of Underlyings per Complex Product based on the Strike of such Underlying.

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Worst-Performing Underlying	out of all the Underlyings, the Underlying in respect of which its Final Level divided by its Strike results in the <b>lowest</b> value.
<b>B.2</b>	<b>Early Redemption</b>
Trigger Redemption	Not applicable
Issuer Call Option	Not applicable
Early Redemption Date	if the Complex Products are redeemed prior to the Final Redemption Date, the date of such early redemption.
<b>B.3</b>	<b>General Redemption Definitions</b>
Initial Fixing Date	1 November 2017, being the date on which the Strike and the Barrier and the Ratio are fixed, and from which date the Complex Products may be traded.
Strike	with respect to each Underlying, the relevant Strike specified in <b>Table A</b> , which is equal to 100% of its Level at the Valuation Time on the Initial Fixing Date.
Level	with respect to each Underlying, its Share Price.
Final Fixing Date	1 November 2018, being the date on which the Final Level will be fixed.
Final Level	with respect to each Underlying, 100% of its Level at the Valuation Time on the Final Fixing Date.
Valuation Time	with respect to each Underlying, its Scheduled Closing Time.
Barrier	with respect to each Underlying, the relevant Barrier specified in <b>Table A</b> , being 69% of its Strike.
Barrier Event	if the Level of any Underlying at any time (observed continuously) on any Barrier Observation Date is <b>at or below</b> its Barrier.
Barrier Observation Dates	each Exchange Business Day during the Barrier Observation Period, being the dates on which the Level of each Underlying is observed for purposes of determining whether a Barrier Event has occurred.
Barrier Observation Period	from and excluding the Initial Fixing Date to and including the Final Fixing Date.
Redemption Date	the Final Redemption Date or, if the Complex Products are redeemed prior to the Final Redemption Date, the Early Redemption Date.

Table A / Tabelle A

Underlying / Basiswert	Strike / Referenzkurs	Barrier / Barriere	Ratio / Bezugsverhältnis
BNP Paribas	EUR 65.95	EUR 45.5055	15.1630
Société Générale SA	EUR 47.80	EUR 32.982	20.9205
Crédit Agricole SA	EUR 14.95	EUR 10.3155	66.8896

### C. Interest, Premium and Payout

#### C.1 Interest

Interest The Issuer shall pay the Interest Amount on each Interest Payment Date, provided that the Complex Products have not been redeemed, repurchased or cancelled prior to such date. For the avoidance of doubt, it being understood that, if the Complex Products are redeemed, repurchased or cancelled prior to the relevant Interest Payment Date, any portion of the Interest Amount that would otherwise be due on such Interest Payment Date that has accrued as of the date of such redemption, repurchase or cancellation will be paid.

▪ Interest Amount 0.00% p.a. of the Denomination, i.e., EUR 0.00 for 180 days, being the amount the Issuer shall pay to the Holders per Complex Product on each Interest Payment Date (unless the Complex Products are redeemed, repurchased or cancelled prior to such date).

▪ Interest Payment Date(s) 7 May 2018 and 6 November 2018, being the date(s) on which the Issuer shall pay the Interest Amount per Complex Product to the Holders.

▪ Business Day Convention notwithstanding Section 8, with respect to each Interest Payment Date, Modified Following Business Day Convention, unadjusted

▪ Day Count Fraction 30/360

#### C.2 Premium

Premium The Issuer shall pay the Premium Amount on each Premium Payment Date, provided that the Complex Products have not been redeemed, repurchased or cancelled prior to such date. For the avoidance of doubt, it being understood that, if the Complex Products are redeemed, repurchased or cancelled prior to the relevant Premium Payment Date, any portion of the Premium Amount that would otherwise be due on such Premium Payment Date that has accrued as of the date of such redemption, repurchase or cancellation will be paid.

▪ Premium Amount 8.00% p.a. of the Denomination, i.e., EUR 40.00 for 180 days, being the amount the Issuer shall pay to the Holders per Complex Product on each Premium Payment Date (unless the Complex Products are redeemed, repurchased or cancelled prior to such date).

▪ Premium Payment Date(s) 7 May 2018 and 6 November 2018, being the date(s) on which the Issuer shall pay the Premium Amount per Complex Product to the Holders.

▪ Business Day Convention notwithstanding Section 8, with respect to each Premium Payment Date, Modified

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Following Business Day Convention, unadjusted

▪ Day Count Fraction 30/360

#### C.3 Payout

Not applicable

#### D. Underlying Specific Definitions and Related Information

Shares each of Share 1, Share 2 and Share 3.

Share 1 one **BNP Paribas Bearer Share** of EUR 2.00 par value issued by the Share Issuer.

With respect to Share 1, any reference in these Terms and Conditions to a term defined below shall be to such term as defined below:

▪ Share Issuer Name and domicile: BNP Paribas, 16, Boulevard des Italiens, 75009 Paris, France

The latest annual report of the Share Issuer may be obtained, free of charge, from the head office of Credit Suisse AG in Zurich via telephone at: +41 44 333 21 44 or via facsimile at: +41 44 333 84 03.

▪ Security Codes Swiss Sec. No.: 123 397  
ISIN: FR 000 013 110 4

▪ Exchange Bloomberg Ticker: BNP FP EQUITY  
Euronext Paris

Share 2 one **Société Générale SA Bearer Share** of EUR 1.25 par value issued by the Share Issuer.

With respect to Share 2, any reference in these Terms and Conditions to a term defined below shall be to such term as defined below:

▪ Share Issuer Name and domicile: Société Générale, Boulevard Haussmann, 75009 Paris, France

The latest annual report of the Share Issuer may be obtained, free of charge, from the head office of Credit Suisse AG in Zurich via telephone at: +41 44 333 21 44 or via facsimile at: +41 44 333 84 03.

▪ Security Codes Swiss Sec. No.: 519 928  
ISIN: FR 000 013 080 9  
Bloomberg Ticker: GLE FP EQUITY

▪ Exchange Euronext Paris

Share 3 one **Crédit Agricole SA Bearer Share** of EUR 3.00 par value issued by the Share Issuer.

With respect to Share 3, any reference in these Terms and Conditions to a term defined below shall be to such term as defined below:

▪ Share Issuer Name and domicile: Crédit Agricole SA, 91-93, Boulevard Pasteur,

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	75015 Paris, France The latest annual report of the Share Issuer may be obtained, free of charge, from the head office of Credit Suisse AG in Zurich via telephone at: +41 44 333 21 44 or via facsimile at: +41 44 333 84 03.	the control of the Issuer provided it has or could reasonably be expected to have a material adverse effect on the ability of the Issuer to perform its obligations under, or hedge its position with respect to, the Complex Products:
▪ Security Codes	Swiss Sec. No.: 1 336 531 ISIN: FR 000 004 507 2 Bloomberg Ticker: ACA FP EQUITY	
▪ Exchange	Euronext Paris	
Underlying Past Performance	For past performance of the Underlyings and their volatility, see <a href="http://www.credit-suisse.com/derivatives">www.credit-suisse.com/derivatives</a> .	(a) any outbreak or escalation of hostilities or other national or international calamity or crisis,
<b>E.</b>	<b>Additional Issue Specific Definitions</b>	(b) the enactment, publication, decree or other promulgation of any statute, regulation, rule or order of any court or other governmental authority, which affects, or would affect, the payment of any amount (or delivery of any other benefit) under the Complex Products,
Business Day	a day (other than a Saturday or Sunday) on which commercial banks and foreign exchange markets settle payments in Zurich and that is a TARGET Business Day.	
TARGET Business Day	any day on which the Trans-European Automated Realtime Gross settlement Express Transfer (TARGET2) system is open for business.	
Clearstream Luxembourg	Clearstream Banking, Luxembourg, as operator of the Clearstream Luxembourg system (42 Avenue JF Kennedy, L-1855 Luxembourg, Luxembourg) and any successor organisation or system.	(c) the taking of any action by any governmental, administrative, legislative, or judicial authority or power of any Jurisdictional Event Jurisdiction, or any political subdivisions thereof, in respect of its monetary or fiscal affairs or stock exchanges which has a material adverse effect on the financial markets,
Clearing System	Clearstream Luxembourg and/or Euroclear and/or SIS	
Euroclear	Euroclear Bank S.A., Brussels, Belgium, as operator of the Euroclear system (Avenue de Schiphol 6, 1140 Brussels, Belgium) and any successor organisation or system.	
Extraordinary Event	(i) the Issuer has determined in good faith that the performance of any of its obligations under the Complex Products or that any arrangement made to hedge its obligations under the Complex Products has or will become, in whole or in part, unlawful, illegal, or otherwise contrary to any present or future law, rule, regulation, judgement, order, directive, policy or request of any governmental, administrative, legislative or judicial authority or power (but, if not having the force of law, only if compliance with it is in accordance with the general practice of persons to whom it is intended to apply), or any change in the interpretation thereof,	(d) the taking of any action by any governmental, administrative, legislative, or judicial authority or power of any Jurisdictional Event Jurisdiction, or any political subdivisions thereof, or of any trading venue in any Jurisdictional Event Jurisdiction, which restricts or otherwise negatively affects the ability of market participants to enter into or continue to hold positions in financial instruments or other assets, or
	(ii) any of the following events (whether or not reasonably foreseeable) outside of	(e) the closing of any Clearing System with no substitution of a successor clearing organization within one week after such closing, or
		(iii) any event similar to any of the events described in clauses (i) and (ii) above, which has had or could reasonably be

## TERMS AND CONDITIONS

	<p>expected to have a material adverse effect on the ability of the Issuer to perform its obligations under, or to hedge its position with respect to, the Complex Products.</p>
Settlement Disruption Event	<p>with respect to any Underlying to be delivered pursuant to Section 2.2, an event beyond the control of the Issuer as a result of which, in the determination of the Issuer, the Issuer cannot deliver, or it would be in contravention of any applicable law or regulation for the Issuer to deliver, such Underlying to the relevant Holder.</p>
SIS	<p>SIX SIS Ltd, the Swiss securities services corporation (Baslerstrasse 100, 4600 Olten, Switzerland), and any successor organization or system.</p>
Unscheduled Termination Amount	<p>means, in respect of a Complex Product,</p> <p>an amount in the Settlement Currency (which may not be less than zero) equal to the fair market value of the Complex Product immediately prior to the exercise of the termination right by the Issuer by way of publication of the termination notice, as calculated by the Calculation Agent using its valuation models and taking into account <i>inter alia</i>, without limitation, the following:</p> <ul style="list-style-type: none"> <li>(A) the time remaining to the maturity of the Complex Product;</li> <li>(B) the interest rates at which banks may obtain funding;</li> <li>(C) the interest rate which the Issuer (or its affiliates) are charged to borrow cash;</li> <li>(D) the value, expected future performance and/or volatility of the Underlying(s); and</li> <li>(E) any other information which the Calculation Agent deems relevant (including, without limitation, the circumstances that resulted in the events giving rise to the termination right),</li> </ul> <p>provided that the Calculation Agent shall in the calculation of the Unscheduled Termination Amount deduct the cost to the Issuer and/or its affiliates of unwinding any Hedging Arrangements in relation to such Complex Products, as determined by the Calculation Agent in its discretion acting in good faith and in a commercially reasonable manner.</p>
Form of Complex Products	<p>Uncertificated Securities</p>
Holder(s)	<p>with respect to any Complex Product, the person holding the Complex Product in a securities account that is in his or her name or, in the case of an intermediary, the intermediary holding the Complex Product for its own account in a securities account that is in its</p>

## TERMS AND CONDITIONS

	<p>name. The Holder of a Complex Product shall, for all purposes, be treated by (i) the Issuer, (ii) the Calculation Agent, (iii) the Paying Agent and (iv) all other persons as the person entitled to such Complex Product and the person entitled to receive the benefits of the rights represented by such Complex Product.</p>
	<p>References to "AED" are to United Arab Emirates dirham, references to "ARS" are to Argentine pesos, references to "AUD" are to Australian dollars, references to "BMD" are to Bermudian dollars, references to "BRL" are to Brazilian real, references to "CAD" are to Canadian dollars, references to "CHF" are to Swiss francs, references to "CLP" are to Chilean peso, references to "CNY" are to Chinese yuan renminbi, references to "COP" are to Colombian peso, references to "CZK" are to Czech koruna, references to "DKK" are to Danish krone, references to "EUR" are to euro, references to "GBP" are to British pounds sterling, references to "HKD" are to Hong Kong dollars, references to "HUF" are to Hungarian forint, references to "IDR" are to Indonesian rupiah, references to "ILS" are to Israeli new shekel, references to "INR" are to Indian rupee, references to "JPY" are to Japanese yen, references to "KRW" are to South-Korean won, references to "MXN" are to Mexican peso, references to "MYR" are to Malaysian ringgit, references to "NOK" are to Norwegian kroner, references to "NZD" are to New Zealand dollar, references to "PLN" are to Polish zloty, references to "RON" are to Romanian new lei, references to "RUB" are to Russian rouble, references to "SGD" are to Singapore dollars, references to "SEK" are to Swedish krona, references to "THB" are to Thai baht, references to "TRY" are to Turkish lira, references to "TWD" are to Taiwan dollars, references to "USD" are to United States dollars, and references to "ZAR" are to South African Rand.</p>



## APPENDIX 3

The appendix number 3 shows the content of Prospectus, considering page's number shall be take in consideration that the original document provides information in English and German language; thus, the real number of pages is the half.

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The information useful for the client which want to evaluate the product described in Appendix 1 and defined in Appendix 2 are available at section Y called Barrier Reverse Convertibles, at page 320. It is an indicator of complexity of the document.

## APPENDIX 4

**ANNEX VI**  
**REGULATION 2017/653**  
**METHODOLOGY FOR THE CALCULATION OF COSTS**  
**PART I**

**(not included I list of cost for UCITS in this Appendix)**

**II. LIST OF COSTS OF PRIPS OTHER THAN INVESTMENT FUNDS**

**Costs to be disclosed**

*One-off costs*

27. A one-off cost is an entry and exit cost which include initial charges, commissions or any other amount paid directly by the retail investor or deducted from a payment received by or due to the retail investor.

28. One-off costs are borne by a PRIP other than an investment fund, whether they represent expenses necessarily incurred in its operation, or the remuneration of any party connected with it or providing services to it. One-off entry costs and charges

29. One-off entry costs and charges include, but are not limited to, the following types that shall be taken into account in the cost amount to be disclosed for PRIPs other than investment funds:

- (a) sales commissions;
- (b) structuring costs, including market-making costs (spread) and settlement costs;
- (c) hedging costs (to ensure that the PRIIP manufacturer is able to replicate the performance of the derivative component of the structured product — these costs include transaction costs)
- (d) legal fees;
- (e) costs for capital guarantee;
- (f) implicit premium paid to the issuer.

*One-off exit costs and charges*

30. One-off exit costs and charges include, but are not limited to, the following types that shall be taken into account in the amount to be disclosed for PRIPs other than investment funds:

- (a) proportional fees;
- (b) bid-mid spread to sell the product and any explicit costs or penalties for early exit applicable. The estimation of the bid-mid spread shall be done in relation to the availability of a secondary market, to the market conditions and the type of product. In the situation where the PRIIP manufacturer (or a related third party) is the only available counterparty to buy the product on the secondary market, it shall estimate the exit costs to be added to the fair value of the product according to its internal policies;
- (c) contract-for-difference (CFD) related costs such as:

- (i) commissions charged by CFD providers — general commission or a commission on each trade — i.e. on opening and closing a contract;
- (ii) CFD trading such as bid-ask spreads, daily and overnight financing costs, account management fees and taxes which are not already included in the fair value.

### *Recurring Costs*

31. Recurring costs are payments regularly deducted from all payments due to the retail investor or from the amount invested.

32. Recurring costs include all types of cost borne by a PRIIP other than an investment fund whether they represent expenses necessarily incurred in its operation, or the remuneration of any party connected with it or providing services to it.

33. The following list is indicative but not exhaustive of the types of recurring charge that, where they are deducted or charged separately, shall be taken into account in the amount to be disclosed:

- (a) costs related to coupon payments;
- (b) costs of the underlying, if any.

### *Costs of PRIIPs referred to in point 17 of Annex IV*

34. One-off exit costs and charges are exchange fees, clearing fees and settlement fees where known.

35. Recurring costs are hedging costs borne under normal market conditions and stressed market conditions. Calculation of implicit costs of PRIIPs other than investment funds

36. For the purposes of the calculation of the implicit costs embedded in PRIIPs, the PRIIP manufacturer shall refer to the issue price and, after the subscription period, to the price available to purchase the product on a secondary market.

37. The difference between the price and the fair value of the product is considered as an estimation of the total entry costs included in the price. If the PRIIP manufacturer is unable to distinguish the relevant implicit costs to be disclosed as referred to in point 29 of this Annex using the difference between the price and the fair value, it shall liaise with the issuer of the different components of the product, or the relevant body, in order to gather the relevant information on those costs.

38. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

39. The fair value policy that governs the measurement of the fair value shall set a series of rules including in the following areas:

- (a) governance;
- (b) methodology for the calculation of the fair value.

40. The rules referred to in point 39 of this Annex shall aim at outlining a valuation process that:

- (a) complies with the applicable accounting standards, in relation to fair value;

- (b) makes sure that internal pricing models for PRIPs are consistent with the methodologies, modelling and standards used by the PRIIP manufacturer to value its own portfolio under the hypothesis that the product is available for sale or held for trading;
  - (c) is consistent with the level of complexity of the product and the type of underlying;
  - (d) takes into account the issuer credit risk and the uncertainty about the underlying;
  - (e) sets the parameters to identify an active market in order to avoid risk mispricing that could lead in extreme cases to significantly inaccurate estimates;
  - (f) maximize the use of relevant observable market inputs and minimizes the use of unobservable inputs.
41. The fair value of a structured product shall be determined on the basis of:
- (a) market prices, where available or efficiently formed;
  - (b) internal pricing models using as an input market values which are indirectly connected to the product, derived from products with similar characteristics (comparable approach);
  - (c) internal pricing models based on inputs which are not derived directly from market data for which estimations and assumptions must be formulated (mark-to-model approach).
42. If the fair value cannot be derived from market prices, it shall be calculated using a valuation technique that is able to represent properly the different factors affecting the product payoff structure making maximum use of market data.
43. The valuation technique referred to in point 42 of this Annex shall consider the following according to the complexity of the product:
- (a) the use of recent arm's length market transactions between knowledgeable, professional counterparties;
  - (b) reference to the current market price of another instrument that is substantially the same;
  - (c) the use of an appropriate discounted cash-flow model where the likelihood of each cash flow is determined using an appropriate model of asset price evolution.
44. In the case of subscription products, the fair value shall be calculated on the date when the product terms are determined. This valuation date shall be close to the beginning of the subscription period. Where long offering periods or high market volatility exists, a criterion to update cost information shall be defined.
45. Where preliminary terms are used, costs shall be calculated by using the minimum terms of the product.
46. Where variable subscription prices are used, a procedure on how to incorporate and disclose the cost effect of the varying subscription price shall be defined.

### III. LIST OF COSTS OF INSURANCE-BASED INVESTMENT PRODUCTS

#### **Costs to be disclosed**

*One-off costs*

47. A one-off cost is an entry and exit cost which includes initial charges, commissions or any other amount paid directly by the retail investor or deducted from the first payment or from a limited number of payments due to the retail investor or from a payment upon redemption or termination of the product.

48. One-off costs are borne by an insurance-based investment product, whether they represent expenses necessarily incurred in its operation, or the remuneration of any party connected with it or providing services to it.

49. One-off costs include, but are not limited to, the following types of entry costs and charges that shall be taken into account in the amount to be disclosed for insurance-based investment products:

- (a) structuring or marketing costs;
- (b) acquisition, distribution, sales costs;
- (c) processing/operating costs (including costs for the management of the insurance cover);
- (d) cost part of biometric risk premiums referred to in point 59 of this Annex;
- (e) costs of holding required capital (up front part to be disclosed insofar as they are charged).

*Recurring costs*

50. Recurring costs are payments regularly deducted from all payments from the retail investor or from the amount invested or amounts that are not allocated to the retail investor according to a profit sharing mechanism.

51. The recurring costs include all types of costs borne by an insurance-based investment product whether they represent expenses necessarily incurred in its operation, or the remuneration of any party connected with it or providing services to it.

52. The following list is indicative but not exhaustive of the types of recurring charge that shall be taken into account in the amount of the 'Other ongoing costs' in table 2 of Annex VII:

- (a) structuring or marketing costs;
- (b) acquisition, distribution, sales costs;
- (c) processing/operating costs (including costs for the management of insurance cover);
- (d) cost part of biometric risk premiums referred to in point 59 of this Annex;
- (e) other administrative costs; 12.4.2017 L 100/45 Official Journal of the European Union EN
- (f) costs of holding capital (recurring part to be disclosed insofar as they are charged);
- (g) any amount implicitly charged on the amount invested such as the costs incurred for the management of the investments of the insurance company (deposit fees, costs for new investments, etc.);
- (h) payments to third parties to meet costs necessarily incurred in connection with the acquisition or disposal of any asset owned by the insurance-based investment product (including transaction costs as referred to in points 7 to 23 of this Annex).

53. Where an insurance-based investment product invests a part of its assets in UCITS or AIFs, in a PRIIP other than UCITS or AIFs or in an investment product other than a PRIIP, points 5(l), 5(m) and 5(n) of this Annex shall be applied respectively.

### **Cost disclosure of the biometric risk premium of insurance based investment products**

#### *Costs part of biometric risk premiums*

54. Biometric risk premiums are those premiums paid directly by the retail investor or deducted from the amounts credited to the mathematical provision or from the participation bonus of the insurance policy, that are intended to cover the statistical risk of benefit payments from insurance coverage.

55. The fair value of biometric risk premiums is the expected present value, according to the interest rates referred to in point 71(a) of this Annex, of the future benefit payments from insurance coverage taking into account the following:

(a) best estimate assumptions on these benefit payments derived from the individual risk profile of the portfolio of the individual manufacturer;

(b) other payoffs related to insurance cover (rebates on biometric risk premiums paid back to the retail investors, increase of benefit payments, reduction of future premiums, etc.) resulting from profit sharing mechanisms (legal and/or contractual).

56. Best estimate assumptions on future benefit payments from insurance coverage shall be set in a realistic way.

57. The estimated future benefit payments shall not include prudency margins or costs for the management of the insurance cover.

58. For manufacturers within the scope of Directive 2009/138/EC these best estimate assumptions shall be consistent with the respective assumptions used for the calculation of the technical provisions in the Solvency II balance sheet.

59. The cost part of biometric risk premiums is the difference between biometric risk premiums charged to the retail investor referred to in point 54 of this Annex and the fair value of the biometric risk premiums referred to in point 55 of this Annex.

60. A PRIIP manufacturer may include the full biometric risk premiums in the calculation of one-off costs or recurring costs in the place of the cost part of those premiums.

## **PART II**

### *Summary cost indicators and compound effect of the costs*

#### **I SUMMARY COST INDICATORS**

61. The summary cost indicator of the PRIIP is the reduction of the yield due to total costs calculated in accordance with points 70 to 72 of this Annex.

62. For the calculation of the summary cost indicator the costs to be disclosed referred to in point 72 of this Annex shall be the total costs. This shall equal for investment funds the sum of the costs as referred to in points 1 and 2 of this Annex plus the sum of the costs as referred to in points 4 and 6 of this Annex; for PRIIPs other than investment funds, except PRIIPs referred in point 17 of Annex IV, the sum of the costs as referred to in points 27 and 28 of this Annex plus the sum of the costs as referred to in points 31 and 32 of this Annex; for PRIIPs referred to in point 17 of Annex IV, the sum of the costs as referred to in points 34 and 35 of this Annex;

and for insurance-based investment products, the sum of the costs as referred to in points 47 and 48 plus the sum of the costs as referred to in points 50 and 51 of this Annex. The total costs shall also include exit penalties, where relevant.

*One-off costs and one-off costs ratios*

63. The entry and exit costs ratio of the PRIIP shall be the reduction of the annual yield due to entry and exit costs calculated according to points 70 to 72 of this Annex.

64. For the calculation of the entry and exit costs ratio the costs to be disclosed referred to in point 72 of this Annex shall for investment funds be the entry and exit costs according to points 1 and 2 of this Annex; points 27 and 28 of this Annex for PRIIPs other than investment funds, except PRIIPs referred in point 17 of Annex IV; point 35 for PRIIPs referred in point 17 of Annex IV; and points 47 and 48 of this Annex for insurance-based investment products. Exit costs shall also include exit penalties, where relevant.

*Recurring costs, portfolio transaction costs and insurance costs/other recurring costs ratios*

65. The portfolio transaction costs, insurance costs and other recurring costs ratio of the PRIIP shall be the reduction of the annual yield due to portfolio transaction costs and other recurring costs calculated according to points 70 to 72 of this Annex.

66. For the calculation of the portfolio transaction costs ratio and the insurance costs ratio the following shall apply:

(a) for the calculation of the portfolio transaction, the costs to be disclosed referred to in point 72 shall be the portfolio transaction costs according to points 7 to 23 of this Annex for investment funds, point 29(c) of this Annex for PRIIPs other than investment funds, except PRIIPs referred in point 17 of Annex IV, and point 52(h) of this Annex for insurance based investment products;

(b) for the calculation of the insurance costs ratio, the costs to be disclosed referred to in point 72 of this Annex shall be the insurance costs according to points 59 and 60 of this Annex for insurance based investment products.

67. The other recurring costs ratio shall be the reduction of the annual yield due to other recurring costs that is calculated as the difference between the summary cost indicator according to point 61 of this Annex and the sum of the one-off costs ratio, according to point 63 of this Annex, plus portfolio transaction costs ratio, according to point 66(a), plus insurance costs ratio, according to point 66(b) of this Annex, plus the incidental costs ratios, according to point 68 of this Annex.

*Incidental costs and incidental costs ratios (performance fees and carried interests ratio)*

68. For the calculation of the performance fees ratio, the cost to be disclosed referred to in point 72 shall be the portfolio incidental costs according to point 6(a) of this Annex for investment funds. For the calculation of the carried interests ratio, the cost to be disclosed referred to in point 72 of this Annex shall be the portfolio incidental costs according to point 6(b) of this Annex for investment funds.

69. The 'ongoing costs', 'performance fees' and 'carried interests' as referred to in Annex VII are respectively the 'recurring costs', 'performance fees ratio' and 'carried interests ratio' as referred to in this Annex and in Article 5.

*Calculation of summary cost indicator*

70. The summary cost indicator shall be calculated as the difference between two percentages  $i$  and  $r$  where  $r$  is the annual internal rate of return in relation to gross payments by the retail



investor and estimated benefit payments to the retail investor during the recommended holding period and  $i$  is the annual internal rate of return for the respective cost free scenario.

71. The estimation of future benefit payments under point 70 of this Annex shall be based on the following assumptions:

(a) except for PRIIPs as referred to in point 17 of Annex IV, the annual internal rate of return, i.e. the performance, of the PRIIP shall be calculated applying the methodology and the underlying hypothesis used for the estimation of the moderate scenario from the performance scenarios section of the key information document;

(b) the benefit payments shall be estimated under the assumption that all costs included in the total costs according to point 62 of this Annex are deducted;

(c) for PRIIPs as referred to in point 17 of Annex IV and for UCITS or non-UCITS funds for which PRIIP manufacturers use the key investor information document in accordance with Article 14(2) of this Regulation, the performance shall be 3 %.

72. For the purpose of the calculation of the cost free scenario as referred to in point 70 of this Annex the following shall apply:

(a) for the calculation of  $i$  either gross payments by the retail investor from the calculation of  $r$  shall be reduced by the costs to be disclosed or the projected benefit payments to the retail investor from the calculation of  $r$  shall be increased under the assumption that the amounts of the costs to be disclosed had additionally been invested. Then  $i$  is the annual internal rate of return in relation to these adjusted payments by and to the retail investor; (

b) where costs to be disclosed can be expressed as a constant percentage of the value of the assets they may be disregarded in the calculation described in point 72(a) of this Annex and instead be added to the percentage of the annual internal rate of return  $i$  for the respective cost free scenario afterwards.

#### *Specific requirements for PRIIPs other than investment funds*

73. For the purpose of the calculation of the cost free scenario as referred to in point 70 of this Annex for PRIIPs other than investment funds, gross payments by the retail investor from the calculation of  $r$ , as referred to in point 72 of this Annex, shall be reduced by the costs to be disclosed.

#### *Specific requirements for insurance-based investment products*

74. For the purpose of the calculations described in points 70 to 72 of this Annex, it shall be assumed that, for insurance-based investment products, no payments resulting from insurance coverage occur during the holding period. That is to say, the calculation of the summary cost indicator shall be solely based on estimated endowment benefit payments.

75. To the extent recurring and one-off costs are covered by explicit costs that are a fixed part of the premium calculation of the product the calculation of recurring and one-off costs shall be based on these explicit costs.

76. For profit participation for insurance based investment products the following shall apply:

(a) when calculating recurring costs and one-off costs for insurance-based investment products amounts retained from the investment return through profit sharing mechanisms shall be considered as costs;

(b) where a part of the costs is returned to retail investors by separate cost bonuses this shall be considered as a cost rebate that reduces cost deductions provided:

(i) that the cost bonuses are declared separately from other parts of the participation bonus and are intended for refunding parts of the costs by the contractual terms of the product.

(ii) that the PRIIP manufacturer can substantiate on the basis of sound actuarial methods that expected future cost bonuses are covered by expected future profits that result from prudent assumptions on future costs.

### ***Calculation of ratios***

#### *Anti-double counting principle*

77. If one type of cost is covered by two or more types of costs as referred to in this Annex, that type of cost shall only be accounted for once in the calculation of the indicators (ratios) which are based on it.

#### *Other specifications*

78. The ratios shall be expressed as a percentage to two decimal places.

79. The ratios shall be calculated at least once a year.

80. The ratios shall be based on the most recent cost calculations which the PRIIP manufacturer has determined. Without prejudice to point 77 of this Annex, the costs are assessed on an 'all taxes included' basis.

As for investment funds the following shall apply:

(a) a separate calculation shall be performed for each share class, but if the units of two or more classes rank *pari passu*, a single calculation may be performed for them;

(b) in the case of a fund which is an umbrella, each constituent compartment or sub-fund shall be treated separately for the purpose of this Annex, but any charges attributable to the fund as a whole shall be apportioned among all of the sub-funds on a basis that is fair to all investors.

81. Apart from the first calculation for a new PRIIP, and if not stated otherwise, the ratios shall be calculated at least once a year, on an ex-post basis. Where it is considered unsuitable to use the ex-post figure because of a material change, an estimate may be used instead until reliable ex-post figures reflecting the impact of the material change become available.

82. The ex-post figures shall be based on recent cost calculations which the PRIIP manufacturer has determined on reasonable grounds to be appropriate for that purpose. The figures may be based on the costs set out in the PRIIP's statement of operations published in its latest annual or half-yearly report, if that statement is sufficiently recent. It is not sufficiently recent, a comparable calculation based on the costs charged during a more recent 12-month period shall be used instead.

83. Information about the ratios that were applicable during previous years/periods shall be published at the location which is specified in the key information document as the general source of further information for investors who require it.

84. Where the costs attributable to an underlying UCITS or AIF are to be taken into account the following shall apply:

(a) the cost indicator of each underlying UCITS or AIF shall be pro-rated according to the proportion of the PRIIP's net asset value which that UCITS or AIF represents at the relevant date being the date at which the PRIIP's figures are taken;

(b) all the pro-rated figures shall be added to the total cost figure of the investing PRIIP itself, thus presenting a single total.

#### *Calculation methodology for new PRIIPs*

85. In place of ex-post data, estimates shall be used in the calculation of the different types of costs. Such estimates shall be carried out by adopting as proxies either a comparable PRIIP or a peer group.

86. For PRIIPs which charge a fixed all-inclusive fee, that fee shall be used provided it includes all costs to be presented under the PRIIPs cost disclosure requirements.

87. For PRIIPs which set a cap or maximum on the amount that can be charged, and provided it includes all costs to be presented under the PRIIPs cost disclosure requirements, that cap or maximum shall be used instead so long as the PRIIP manufacturer gives a commitment to respect the published figure and to absorb any costs that would otherwise cause it to be exceeded.

88. If, in the PRIIP manufacturer's opinion, expressing a figure to two decimal places would be likely to suggest a spurious degree of accuracy to investors, it shall be sufficient to express that figure to one decimal place.

89. The PRIIP manufacturer shall ensure that the accuracy of the estimated figure is kept under review. The PRIIP manufacturer shall determine when it is appropriate to begin using ex-post figures rather than an estimate; but in any case it shall, no later than 12 months after the date on which the PRIIP was first offered for sale in any Member State, review the accuracy of the estimate by calculating a figure on an ex-post basis.

## II COMPOUND EFFECT OF THE COSTS

#### *Common requirements to all types of PRIIPs*

90. The table(s) referred to in Article 5 shall contain an indication of the total costs in monetary and percentage terms for the case that the retail investor invests, respectively 10 000 EUR (for all PRIIPs except regular premium insurance-based investment products), or 1 000 EUR yearly (for regular premium insurance-based investment products) during different holding periods, including the recommended holding period. The holding periods to be shown are those referred to in points 14 to 16 of Annex IV. Where a product is considered not to have an alternative liquidity facility promoted by the PRIIP manufacturer or a third party, or where there is an absence of liquidity arrangements, or for those PRIIPs as referred to in point 17 of Annex IV, that indication of costs may be shown only at maturity or at the end of the recommended holding period.

91. Where the currency of the PRIIP is not in Euros, an amount of a similar magnitude to those set out in point 90 of this Annex and which is cleanly divisible by 1 000 shall be used.

92. The total costs shall include one-off, recurring and incidental costs, and, where relevant, exit penalties.

93. Exit penalties are to be distinguished from other exit costs which have to be paid in any case and therefore always need to be included in the one-off costs.

94. The relevance of exit penalties depends on the holding period of the investment and the exact moment when the products cashed in. Exit penalties depends on the holding period of the investment is kept for the recommended holding period.

## APPENDIX 5

It is exposed the tables settled by Regulation 2016/1800, that shall be followed for the conversion of credit rating in Credit Quality Steps

## ANNEX

## Allocation of credit assessments of external credit assessment institutions to an objective scale of credit quality steps

Credit quality step	0	1	2	3	4	5	6
<b>AM Best Europe-Rating Services Ltd</b>							
Long-term issuer credit ratings scale	aaa	aa+, aa, aa-	a+, a, a-	bbb+, bbb, bbb-	bb+, bb, bb-	b+, b, b-	ccc+, cc, ccc-, cc, c, rs
Long-term debt ratings scale	aaa	aa+, aa, aa-	a+, a, a-	bbb+, bbb, bbb-	bb+, bb, bb-	b+, b, b-	ccc+, cc, ccc-, cc, c, d
Financial strength ratings scale		A+, A+	A, A-	B+, B+	B, B-	C+, C+	C, C-, D, E, F, S
Short-term ratings scale		AMB-1+	AMB-1-	AMB-2, AMB-3	AMB-4		
<b>ARC Ratings SA</b>							
Medium- and long-term issuers rating scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D
Medium and long-term issues rating scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D
Short-term issuers rating scale		A-1+	A-1	A-2, A-3	B, C, D		
Short-term issues rating scale		A-1+	A-1	A-2, A-3	B, C, D		
<b>ASSEKURATA Assekuranz Ratings-Agentur GmbH</b>							
Long-term credit rating scale	AAA	AA	A	BBB	BB	B	CCC, CC/C, D
Short-term corporate rating scale		A++	A		B, C, D		
<b>Avesor SA</b>							
Global rating scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D, E
<b>BCRA — Credit Rating Agency AD</b>							
Bank long-term ratings scale	AAA	AA	A	BBB	BB	B	C, D
Insurance long-term ratings scale	iAAA	iAA	iA	iBBB	iBB	iB	iC, iD
Corporate long-term ratings scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D
Municipality long-term ratings scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D

Issue long-term ratings scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D
Bank short-term ratings scale		A-1+	A-1	A-2, A-3	B, C, D		
Corporate short-term ratings scale		A-1+	A-1	A-2, A-3	B, C, D		
Municipality short-term ratings scale		A-1+	A-1	A-2, A-3	B, C, D		
Issue short-term rating scale		A-1+	A-1	A-2, A-3	B, C, D		
<i>Banque de France</i>							
Global long-term issuer credit ratings scale	3++	3+	3	4+	4, 5+	5, 6	7, 8, 9, P
<i>Capital Intelligence</i>							
International long-term issuer rating scale	AAA	AA	A	BBB	BB	B	C, RS, SD, D
International long-term issue rating scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D
International short-term issuer rating scale		A-1+	A-1	A-2, A-3	B, C, D		
International short-term issue rating scale		A-1+	A-1	A-2, A-3	B, C, D		
<i>Cerved Rating Agency Sp.A.</i>							
Corporate long-term rating scale	A1.1	A1.2, A1.3	A2.1, A2.2, A3.1	B1.1, B1.2	B2.1, B2.2	C1.1	C1.2, C2.1
<i>Creditreform Ratings AG</i>							
Long-term rating scale	AAA	AA	A	BBB	BB	B	C, D
<i>CRIF S.p.A.</i>							
Global long-term rating scale	AAA	AA	A	BBB	BB	B	CCC, D1, D2
<i>Dagong Europe Credit Rating</i>							
Long-term credit rating scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D
Short-term credit rating scale		A-1		A-2, A-3	B, C, D		

<i>DBRS Ratings Limited</i>							
Long-term obligations rating scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D
Commercial paper and short-term debt rating scale		R-1 H, R-1 M	R-1 L	R-2, R-3	R-4, R-5, D		
Claims paying ability rating scale		IC-1	IC-2	IC-3	IC-4	IC-5	D
<i>European Rating Agency</i>							
Long-term rating scale			AAA, AA, A	BBB	BB	B	CCC, CC, C, D
Short-term rating scale			S1	S2	S3, S4, NS		
<i>EuroRating Sp. z o.o.</i>							
Global long-term rating scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D
<i>Euler Hermes Rating</i>							
Global long-term rating scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, SD, D
<i>FERI EuroRating Services AG</i>							
FERI EuroRating rating scale	AAA	AA	A	BBB, BB	BB	B	CCC, CC, C, D
<i>Fitch France S.A.S., Fitch Deutschland GmbH, Fitch Italia SpA, Fitch Polska SA, Fitch Ratings España S.A.U., Fitch Ratings Limited UK, Fitch Ratings CIS Limited</i>							
Long-term issuer credit ratings scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, RD, D
Corporate finance obligations — Long-term ratings scale	AAA	AA	A	BBB	BB	B	CCC, CC, C
Long-term international IFS ratings scale	AAA	AA	A	BBB	BB	B	CCC, CC, C
Short-term rating scale		F1+	F1	F2, F3	B, C, RD, D		
Short-term IFS ratings scale		F1+	F1	F2, F3	B, C		
<i>GDB-Rating Gesellschaft für Bonitätsbeurteilung GmbH</i>							
Global long-term rating scale	AAA	AA		A, BBB	BB	B	CCC, CC, C, D

<b>ICAP Group S.A</b>							
Global long-term rating scale			AA, A	BB, B	C, D	E, F	G, H
<b>Japan Credit Rating Agency Ltd</b>							
Long-term issuer ratings scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, LD, D
Long-term issue ratings scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D
Short-term issuer ratings scale		J-1+	J-1	J-2	J-3, NJ, LD, D		
Short-term issue credit ratings scale		J-1+	J-1	J-2	J-3, NJ, D		
<b>Kroll Bond Rating Agency</b>							
Long-term credit rating scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D
Short-term credit rating scale		K1+	K1	K2, K3	B, C, D		
<b>Moody's Investors Service Cyprus Ltd, Moody's France S.A.S., Moody's Deutschland GmbH, Moody's Italia S.r.l., Moody's Investors Service España SA, Moody's Investors Service Ltd</b>							
Global long-term rating scale	Aaa	Aa	A	Baa	Ba	B	Caa, Ca, C
Bond fund rating scale	Aaa-bf	Aa-bf	A-bf	Baa-bf	Ba-bf	B-bf	Caa-bf, Ca-bf, C-bf
Global short-term rating scale		P-1	P-2	P-3	NP		
<b>Standard &amp; Poor's Credit Market Services France S.A.S., Standard &amp; Poor's Credit Market Services Italy S.r.l., Standard &amp; Poor's Credit Market Services Europe Limited</b>							
Long-term issuer credit ratings scale	AAA	AA	A	BBB	BB	B	CCC, CC, R, SD/D
Long-term issue credit ratings scale	AAA	AA	A	BBB	BB	B	CCC, CC, C, D
Insurer financial strength ratings scale	AAA	AA	A	BBB	BB	B	CCC, CC, SD/D, R
Fund credit quality ratings scale	AAAF	AAF	Af	BBBf	BBf	Bf	CCCF
Mid market evaluation ratings scale			MM1	MM2	MM3, MM4	MM5, MM6	MM7, MM8, MMD
Short-term issuer credit ratings scale		A-1+	A-1	A-2, A-3	B, C, R, SD/D		
Short-term issue credit ratings scale		A-1+	A-1	A-2, A-3	B, C, D		



Scope Rating						
Global long-term rating scale	AAA	AA	A	BBB	BB	CCC, CC, C, D
Global short-term rating scale		S-1+	S-1	S-2	S-3, S-4	
Spread Research						
International long-term rating scale	AAA	AA	A	BBB	BB	CCC, CC, C, D
<i>The Economist Intelligence Unit Ltd</i>						
Sovereign rating band scale	AAA	AA	A	BBB	BB	CCC, CC, C, D



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