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Mind Your KIIDs!

On 24 April 2014, the Financial Conduct Authority (the '**FCA**') published its final notice to Invesco Asset Management Limited and Invesco Fund Managers Limited (together, '**Invesco**') imposing a fine of STG £18,643,000 (reduced from over STG £26,632,900 due to a discount because Invesco agreed to settle at an early stage) for certain internal control failures and for failing to ensure that certain Invesco UCITS' key investor information documents ("**KIID**") complied with the applicable legislation. In particular, the FCA found that the relevant KIIDs did not comprehensively detail the downside risk associated with the use of derivatives.

This note briefly summarises the KIID requirements under Directive 2008/65/EC ("**UCITS IV**"), the reasons given by the FCA for the fine imposed on Invesco and some thoughts as to how UCITS and their management companies may avoid a similar penalty.

The approach of the FCA serves as a reminder for UCITS and their management companies of the need to regularly review their internal controls and their KIID disclosures. It is important to note that less than STG £1,878,536 of the total fine related to breaches of the KIID legislation. The bulk of the fine related to a breach by Invesco of relevant investment restrictions.

UCITS IV – KIID Requirements

The KIID is a short two page (or three page for a structured UCITS) summary document that UCITS are required to produce and provide to investors pre-contract free of charge. The obligation to produce a KIID was introduced as a result of the implementation of UCITS IV in the EU in 2012. Articles 78 to 82 of UCITS IV make provision for the KIID and, in particular, Article 78(2) provides: "*Key investor*

For further information on any of the issues discussed in this article please contact:

Michele Barker
DD:+ 353 (0)1 673 1886
michele.barker@dilloneustace.ie

information should include appropriate information about the essential characteristics of the UCITS concerned, which is to be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product that is being offered to them and, consequently, to take investment decisions on an informed basis".

The European Commission's Regulation 583/2010 (the "**KIID Regulation**") contains further information on the content/information which must be incorporated into a KIID. The general obligation is that it must be drafted in a clear and concise manner, in language which makes it easily understood by the average retail investor and must avoid use of technical and legal jargon. In particular, it should not be presented or delivered in a way that is likely to lead investors to consider it less important than other information about the UCITS and its risks and benefits. In addition, the KIID must follow the running order of the ESMA template.

Derivatives Disclosure

According to the Final Notice which was published by the FCA various Invesco UCITS funds made use of leverage through derivatives and investors in these funds were therefore exposed to increased levels of risk through Invesco managers' use of derivatives during the relevant period. The KIID Regulation provides that a KIID must contain a narrative explanation of risks which are materially relevant to the UCITS. In this regard, the KIID for the relevant Invesco equity funds, which replaced the simplified prospectuses ('**SP**'), did disclose the use of derivatives. The wording of the disclosure stated as follows:

'The Fund may use derivatives (complex instruments) in an attempt to reduce the overall risk of the investments or reduce the costs of investing, although this may not be achieved.'

The FCA considered this to be an inadequate disclosure as it only highlighted the potential benefits that may arise from the use of derivatives and not the downside risks. The FCA felt that investors were misled as to specific risks that they should have been made aware of before making a decision to invest and indeed, they may not have made the same decision to invest had adequate disclosures been inserted.

At the request of the FCA in August 2012, Invesco amended the relevant wording in their KIIDs to include a clearer reference to the risk associated with Invesco's use of derivatives. The revised KIIDs state: "*Investments in the Fund may include financial derivative instruments. Such instruments may be used to obtain, increase or reduce exposure to underlying assets and may create gearing; therefore their use may result in greater fluctuations of the Net Asset Value of the Fund. The Manager will ensure that the use of derivatives does not materially alter the overall risk profile of the Fund".* UCITS Managers should therefore bear this wording in mind when drafting derivative disclosures for KIIDs.

The Central Bank's Guidance Note 1/11 requires KIIDs to be updated annually within 35 days of each calendar year. However, as funds evolve, a fund is required to update its KIIDs if:

- any changes are made to the prospectus or fund rules; or

- the fund is entering any new initiative that is likely to result in a significant amount of new investors subscribing in the fund.

It is instructive to note (and what is somewhat alarming) that the FCA found Invesco's disclosures relating to the use of derivatives to be insufficient even though the level of leverage used was only 5% of the NAV (at its highest point) and the relevant prospectuses allowed for the use of leverage of up to 20% of the NAV; i.e. the level of leverage employed by the relevant fund was significantly less than the level which was permitted under the relevant prospectuses.

Synthetic Risk and Reward Indicator ("SRRI")

The FCA found that a disclosure (by virtue of the SRRI) was not sufficient to comply with the requirements of Article 8 of the KIID Regulation. Article 8 of the KIID Regulation provides that KIIDs must use a SRRI and a narrative explanation of all risks that are materially relevant to the fund which are materially relevant to the fund and which are not adequately captured by the SRRI.

A SRRI is a numerical scale from 1 to 7 based on the volatility of a UCITS past performance, with 1 indicating a low risk and reward and 7 indicating a high risk and reward potential; thus simplifying an investor's ability to compare products. The SRRI of the relevant Invesco UCITS funds as disclosed in the KIID was set at 6 out of 7. This indicated a relatively high level of volatility.

The FCA ultimately found that Invesco's disclosure (by virtue of the SRRI) that there was a high level of volatility associated with the relevant fund was not a substitute for incorporating a narrative explanation of all risks which are materially relevant to the fund. In other words, even though it was reasonably apparent from the SRRI that the relevant Invesco funds were quite volatile this disclosure was not sufficient in the FCA's view to comply with Article 8 of the KIID Regulation.

Systems and Controls

The FCA found that Invesco failed to record trades in all fixed income funds on a timely basis. At least 9% of such trades between 2010 and 2011 were not recorded on the day of execution. This increased the risk that the NAV was inaccurate on such occasions, which in turn increased the risk that investment decisions, compliance checks and pricing were inaccurate having been based on an inaccurate NAV.

In addition, no adequate front office controls existed to ensure the fair distribution of partially executed aggregated trades amongst all fixed income funds. This increased the risk that fund managers could have prejudiced investors by unfairly allocating stocks between funds.

Furthermore, the FCA discovered 33 trades made between 1 May 2008 and 16 November 2012 which breached certain investment restrictions.

Conclusion

The fine imposed on Invesco highlights the importance of comprehensive and accurate drafting of KIID disclosures and the need to ensure that KIIDs are kept up-to-date. In addition, such disclosures should include full disclosures of both positive and negative implications of the relevant asset management techniques utilised by the relevant investment manager. In addition, the disclosure of a risk indicator in the SRRI cannot be utilised as a substitute for clear language containing a complete disclosure of the relevant risks. UCITS and their management companies should bear in mind the requirement to update KIIDSs at least on an annual basis and if there are any changes to the prospectus or fund rules or where a fund is entering any new initiative that is likely to result in a significant amount of new investors acquiring units in the fund.

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Author : Michele Barker

DILLON EUSTACE

Dublin
33 Sir John Rogerson's Quay, Dublin 2, Ireland. Tel: +353 1 667 0022 Fax: +353 1 667 0042.

Cayman Islands
Landmark Square, West Bay Road, PO Box 775, Grand Cayman KY1-9006, Cayman Islands. Tel: +1 345 949 0022 Fax: +1 345 945 0042.

Hong Kong
604 6F Printing House, 6 Duddell Street, Central, Hong Kong. Tel: +852 352 10352.

New York
245 Park Avenue, 39th Floor, New York, NY 10167, U.S.A. Tel: +1 212 792 4166 Fax: +1 212 792 4167.

Tokyo
12th Floor, Yurakucho Itocia Building, 2-7-1 Yurakucho, Chiyoda-ku, Tokyo 100-0006, Japan. Tel: +813 6860 4885 Fax: +813 6860 4501.