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Are You KIDing Me?

PRIIPS, KIDS, and New Obstacles for Americans Buying ETFs in the EU

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INTRODUCTION

Between 2010 and 2016, many American Investors outside of the United States faced account closure. While in certain cases, American investors may have been forced out because their custodian recently reinterpreted the laws in the country where they reside, the changes were often made because of new interpretations of U.S. law or new understandings of their own business practice (see our history of the laws "Why Is It So Hard to Open Investment Accounts for Americans Abroad"). As a result of these laws, many investors couldn't buy Mutual Funds outside of the United States and turned to ETFs for their investing.

The world of ETF investing became complicated as of January 1st, 2018, when a new regulatory behemoth started affecting the dealings of European-based U.S. investors: that of the European Union's Packaged Retail Investment and Investment Products (PRIIPs) guideline. These rules have required all investment products (including U.S. ETFs) to produce a Key Information Document or KID for EU-domiciled retail investors. So far no U.S.-based ETFs have produced KIDs.

PRIPPs and KIDs are part of the comprehensive regulatory reform known as Markets in Financial Instruments Directive (MiFID) II, this directive has "extra-jurisdictional reach," which means the headquarters of where the products are being produced doesn't matter. The location of the brokerage or custodian doesn't matter. The location of the financial advisor handling the products doesn't matter. The only thing that matters is that investors are EU-domiciled. **IF AN INVESTOR LIVES IN THE EU, THIS REGULATION APPLIES TO THEM.**

WHAT DOES THIS MEAN FOR RETAIL INVESTORS?

For Americans in the European Union who have recently been scarred by sudden account closures or situations where their accounts have been liquidated will be forgiven for having a feeling of deja vu. And as a result of these rules, several brokerages that have continued to work with expat clients have started restricting their access to U.S. ETFs. However, while this will present complications for Americans residing in Europe, the situation is manageable with proper guidance and advice; as with all financial difficulties, investors need a plan.

The first and easiest option for most American investors would be to have U.S.-based asset management firms such as State Street, BlackRock, and Vanguard produce KIDs. As of writing, most asset management firms have declined to do so and have no plans to do so for their U.S.-based ETFs. There are several reasons for this reluctance including worries about these documents posing problems with U.S. regulators and the need for the documents to be in the local language as well as English.

That said, the situation facing Americans is quite similar to what happened with regards to mutual fund sales outside of the United States: while holders of ETFs in the European Union will not be able to purchase additional ETFs, they will not have to suddenly liquidate their investments. They can continue to hold any ETFs they've already invested in: for retirees or others who are drawing down their portfolio, they can manage their liquidity needs and manage their portfolio's risk tolerance simply by strategic selling of these assets.

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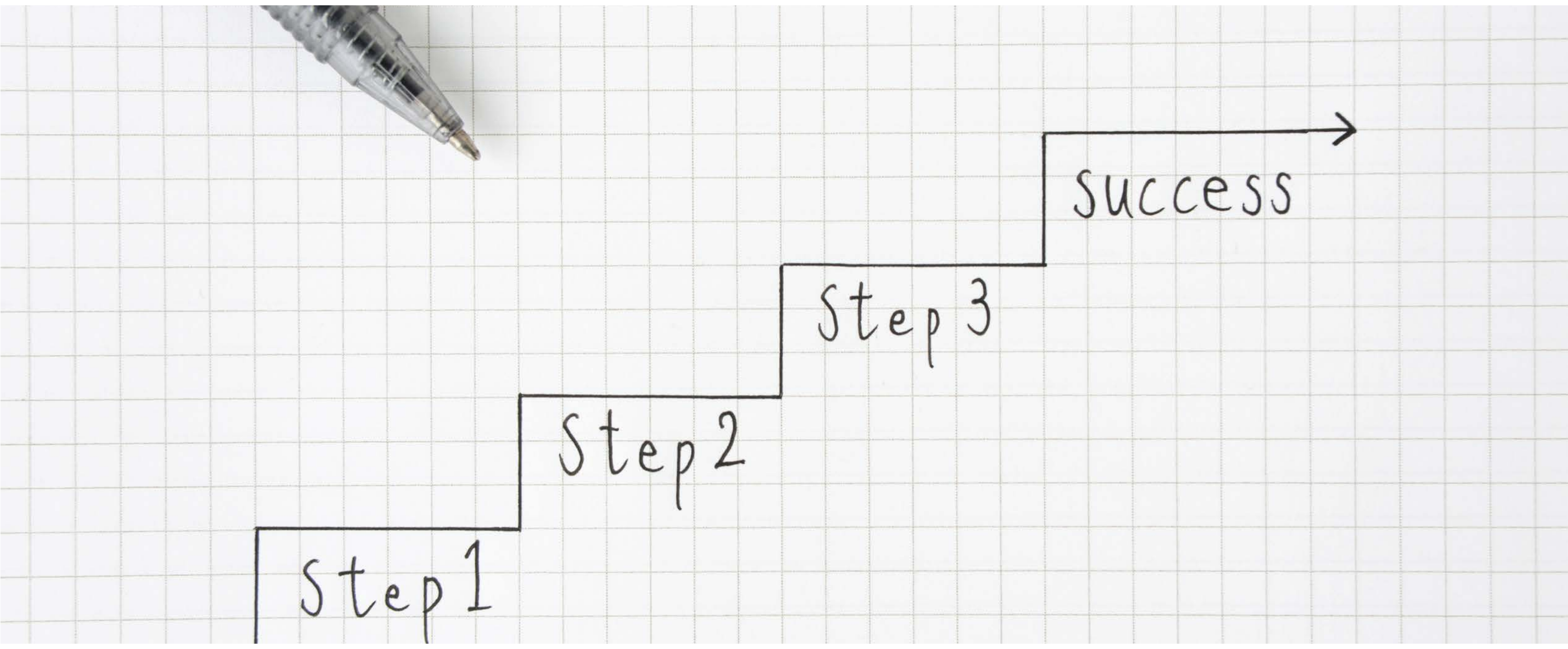
The second solution for Americans who may split time between the U.S. and Europe or have homes in both places, simply maintaining their U.S. address as their brokerage address would eliminate this concern. As they are non-residents in the European Union for the purposes of their custodian, restrictions regarding European residents will not apply.

Another solution is possible for Americans who own the majority of their assets in retirement accounts. In this particular case, they won't face the punitive taxation from the U.S. side that they might should they invest in European ETFs. That is to say, rather than buying a U.S.-based ETF for the S&P 500 (such as SPY or VOO), they can buy a European equivalent that has a KID (for example CSPX or VUSA). However, they must have access to a brokerage which supports trading in multiple jurisdictions: many, if not most, U.S.-based brokerages prohibit investors from buying on foreign markets or non-U.S.-based funds (because of worries about PFICs) and this case would be no exception. However, PFICs held in a tax-advantaged account would be maintained in the same way as other investments and any sales would be tax-deferred until they are withdrawn when they are charged at an investors income tax rate. Thus, should an investor need to rebalance, buy more assets or perform other maneuvers in their accounts, they can do so through European ETFs, etc.



Additionally, retail investors, should they meet certain conditions, and can qualify as professional investors from the perspective of the European Union, can continue to invest in U.S. ETFs. Generally speaking, becoming a "professional" requires meeting two of the following three conditions: certain asset levels, a certain level of relevant experience in the financial industry (generally, one year), and/or "significant" trading in their account over the previous twelve months.

For many American investors in Europe committed to maintaining an ETF-only strategy, these solutions may prove sufficient. There may also be additional strategies-- which may also make sense from an estate planning or tax efficiency position-- involving establishing a U.S. Trust (though as we've noted elsewhere Trusts can be very problematic depending on the asset level and country!) or U.S. corporation to hold investments. Such strategies are dependent on the situation and can be very costly both in upfront and long-term trust or corporate accounting fees.

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However, investors can also pursue a new strategy and no longer use ETFs as their primary investment strategy by investing in individual stocks. Americans may do this through several approaches. For instance, through a technique known as direct indexing (also described here), investors may construct a mini-index for themselves, as 20-30 stocks will generally replicate the performance and structure of an index. However, investors who pursue this strategy will face additional obstacles as it is difficult and often expensive to buy a wide variety of companies outside of the U.S. While many are available as American Depositary Receipts (ADRs), the commission costs are higher, the spreads (the difference between what the buyer is offering and the seller wants to pay) are wider, and there may also be carrying charges as the ADRs are held and issued by banks. Moreover, in many cases, these don't trade that often. Again, however, should an investor have access to a truly global trading platform, they can frequently buy the required stocks for portfolio diversification on a European or Asian exchange at a lower cost.

In addition to this closet index for equities, investors can construct a bond-ladder via individual government bonds for their fixed-income investments. Moreover, such a bond ladder can be tailored to fit their local currency requirements (someone living in the EU would prefer to receive more of their income in Euros and avoid the costs associated with converting currency, for instance) and risk tolerance more precisely than an ETF. Such an investor may also wish to tolerate some currency risk and diversify their portfolio to bonds with higher yields or stronger currency.

However, many retail investors may find these options maddeningly difficult to put into practice or they may find that life leaves them with little time to manage and monitor these investments. For those investors facing that concern, there is an additional solution for Americans considering their money management options: separately managed accounts or "SMA". A separately managed account means that investors hold individual stock positions that are managed by an outside money manager. Such a manager may also run a mutual fund with a similar strategy, but an SMA allows for further customization. As Investopedia describes:

> In other words, if you set up a separate account with Money Manager X, then Manager X has the discretion to make decisions for this account that may be different from decisions made for other accounts [managed by the same Money Manager X].

These funds allow the investor to suggest additional parameters: including socially responsible investing, and maximizing tax efficiency (which should be a major concern for international investors). Moreover, because they often only contain 30 stocks (versus 100 in a Mutual fund), they can provide "alpha" compared to similar mutual funds, ETF and indices. Generally, these funds have restrictions the most major one being investors must allocate at least 100,000 USD for such allocations. And a globally diversified strategy can often be created around an equity portfolio as small as 200,000 USD.

CONCLUSION

The list of acronyms has always been too long for non-U.S.-based American taxpaying investors (PFICs, FATCA, etc.) and the emergence of the additional acronyms of PRIIPs and KIDs to the average investor's portfolio means that once safe-harbors for Americans abroad (ETFs) are no longer that way. To reiterate, the restriction is extra-jurisdictional and will apply to all accounts held by European residents whether or not they are using U.S.-based brokerages or not. While some U.S.-based custodians have moved slower in implementing their enforcement on this issue, all brokerages and custodians who work with EU-based clients will need to come into compliance with these issues and this framework.

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