ICMA proposed approach to sustainability-related amendments to product governance and MiFID II Delegated Directive

Background

1. Under the amending MiFID II Delegated Directive, from 22 November 2022, manufacturers will need to:

   "identify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client with whose needs, characteristics and objectives, including any sustainability related objectives, the financial instrument is compatible."

   (Article 9(9), Delegated Directive (EU) 2017/593 (as amended) – **MiFID II DD**.)

2. *"Sustainability related objectives"* are not defined. But in assessing whether a product meets the target market's identified needs, characteristics and objectives, firms should examine (amongst other things) whether the instrument's *"sustainability factors, where relevant, are consistent with the target market"* (Article 9(11)(b) MiFID II DD).

3. *"Sustainability factors"* are very broadly defined in the Regulation on sustainability-related disclosures in the financial services sector (Regulation (EU) 2019/2088 – **SFDR**) to mean:

   "environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters" (Article 2(24) SFDR).

4. ESMA has published a Consultation *Review of the Guidelines on MiFID II product governance requirements* (**ESMA CP**), which includes proposals for guidelines on the specification of any sustainability-related objectives a product is compatible with.

5. The ESMA CP closes on 7 October 2022. ESMA intends to publish a final report in Q1 2023. This final report will therefore not be available until after the application of the amendments to the MiFID II DD.

Summary position

6. It is still possible to have a target market without specifically identifying compatibility of the product with *"sustainability-related objectives"*.

7. Previous arguments, that the product governance rules focus on the product rather than the issuer, can still be made.

8. The principle of proportionality continues to apply, and so for vanilla instruments, such as bonds, it remains possible to take a higher-level approach to the target market identification.

9. For most bonds, the instrument does not have any *"sustainability factors"* and so is always compatible with the needs, characteristics and objectives (sustainability related or otherwise) of professional investors and eligible counterparties (ICMA institutional-only approach published in

December 2017 – **ICMA1**) and indeed all retail investors (ICMA retail-inclusive approach published in December 2017 – **ICMA2**).

10. Even where a bond is being specifically marketed as having sustainability features, for example in the case of a green, social or sustainable use of proceeds bond or sustainability-linked bond (**sustainable bond**), it remains possible for manufacturers to identify a target market at a high level without identifying a positive target market that specifically includes compatibility with any *"sustainability-related objectives"* based on the approach and rationale set out below.

11. An issuer of a bond itself may, at an entity level, make specific E, S or G claims and therefore represent an investment opportunity which is aligned with the sustainability-related objectives of one or more investors. However, adoption of a target market based upon the issuer itself - rather than the product or financial instrument - would be inconsistent with historic and current market understanding of the MiFID product governance obligations (as relating to the syndicated flow/bond market, as well as the approach taken in the context of equity capital markets pursuant to the AFME ECM Protocol for ordinary shares).

12. It is helpful that the MiFID II DD (Article 9(9)) and the ESMA CP (Draft Guidelines para 81) make it clear that manufacturers are not required to identify a negative target market with respect to sustainability factors/alignment with sustainability-related objectives.

13. As with the original ICMA1 and ICMA2 approaches, the position in this paper does not purport to be exhaustive or exclusive.

ICMA1 (institutional-only) approach

14. No change to ICMA1 legend (as output of the manufacturer(s)' initial target market assessment) for either bonds where the product itself is not being marketed as having any sustainability features (**conventional bonds**) or sustainable bonds.

15. Even for sustainable bonds, this would be the optimal approach for continued frictionless operation of the syndicated bond market – where issuers rely on an ability to access the market in an agile manner with banks forming a syndicate and agreeing documentation (including the initial target market) at short notice, including pricing intra-day.

16. This approach can be substantiated on the basis that the target market is professional investors and eligible counterparties only and, as per the original conclusion of the ICMA1 approach, based upon the target market assessment following the 5 ESMA categories.

17. At a high level, this is because professional investors are knowledgeable and experienced with sophisticated (and often confidential) investment strategies; they are consequently seeking unhindered access to the full range of bond market products.

18. Mandatory and market-standard disclosures are expected to provide professional investors (including distributors and end investors) with sufficient information regarding the nature of the product to make an assessment of the product against their individual client(s)' / their own investment objectives.

19. Considering further the detail set out in the ESMA CP regarding the identification of sustainability-related objectives as part of the target market assessment, in ESMA's view this should be done within the broader category of clients' objectives and needs (see para 24 of ESMA CP).

20. See Schedule 1 of the ICMA1 approach which, in relation to *"Clients' objectives and needs"*, states:

    "Professional investors have carefully considered and developed investment objectives (which may have multiple elements and strands and which may vary from time to time) as well as a sufficient ability to determine their own bond investment objectives and the role of individual bonds within them; they also have a sufficient understanding of all specifications of an investment in bonds and how such an investment would fit within their needs and expectations. In light of the above, all channels for distribution of the bonds to eligible counterparties and professional clients are appropriate."

21. The ICMA1 approach already addresses not just the financial but also the extra-financial aspects of bonds – including any preferences related to ESG, Sharia-compliance, etc. However, manufacturers may wish to update their internal processes to reflect any changes to the initial target market assessment to take into account the specific sustainability-related amendments to the MiFID II DD and additional points reflected in the ESMA CP.

22. See amended ICMA1 Schedule 1 (*"Professional investors target market assessment"*) published by ICMA on 5 October 2022 to reflect the amendments to the MiFID II DD and the ESMA CP.

ICMA2 (retail-inclusive) approach

23. The ICMA2 approach to MiFID II product governance in the Eurobond markets (i.e. the syndicated cross border flow context) encompasses three broad categories of transactions for which manufacturers may contemplate a broad retail target market. These comprise: (i) Base case 'A' – Bonds that are not ESMA complex bonds;[1] (ii) Variant 'B' – Certain ESMA complex bonds; and (iii) Variant 'C' – EEA-related official borrowers.[2] The ICMA2 approach applies to low denomination bonds admitted to trading on an EEA regulated market, and so within the contemplation of the EU's related initial and ongoing transparency regimes (or analogously subject to similar transparency).[3]

24. The proportionate ICMA2 approach *inter alia*, in terms of clients' objectives and needs, notes that, given the nature of listed bonds which are not ESMA complex (including those of EEA-related official borrowers) and the amount of information available through mandatory and market-standard disclosures and otherwise generally available, a typical retail investor has sufficient ability to determine its investment objectives regarding such bonds, how such an investment would fit within that investor's needs and expectations and access to the extent it requires or wishes to IFAs and other independent advisers, who can advise their clients on, amongst other things, investment horizon and the compatibility of such bonds with the needs of clients who seek a contracted repayment of the amount invested and a predictable return profile. Similarly, certain ESMA complex bonds (including those of EEA-related official borrowers), though technically ESMA complex, do not include any additional risks relating to the expected return that are difficult to understand. In this respect, the ICMA2 approach also already addresses not just the financial, but also the extra-financial aspects of such bonds – including any preferences related to ESG, Sharia-compliance, etc.

[1] For MiFID II purposes, and the purposes of the ICMA2 approach, *"ESMA complex"* bonds are those *"that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved"*, following the ESMA February 2016 Guidelines on complex debt instruments and structured deposits. Following the UK's departure from the EU, the market does not currently perceive any material difference between UK and the EEA in terms of what is *"(non-)complex"*.

[2] Market practice has applied this analogously to UK-related official borrowers following the UK's departure from the EU.

[3] Market practice has applied this rationale to bonds admitted to trading on the UK regulated market following the UK's departure from the EU, given the analogous initial and on-going transparency.

25. ***Base case 'A' – Bonds that are not ESMA complex bonds***

    (A) No change to ICMA2 legend (as output of the manufacturer(s)' initial target market assessment) for either (i) conventional bonds or (ii) sustainable bonds.[4]

    (B) The continued application of the current approach for non-complex bonds is defensible on the basis that the product governance regime is intended to be interpreted and applied on a proportionate basis and non-complex bonds can be bought by retail investors on an execution-only basis outside the appropriateness regime.

26. ***Variant 'B' – Certain ESMA complex bonds*** – No change to ICMA2 legend (as output of the manufacturer(s)' initial target market assessment) for either (i) conventional bonds or (ii) sustainable bonds.[5] See Base case 'A' above.

27. ***Variant 'C' – EEA-related official borrowers*** – No change to ICMA2 legend (as output of the manufacturer(s)' initial target market assessment) for either (i) conventional bonds or (ii) sustainable bonds. See Base case 'A' above.

28. Manufacturers may wish to update their internal processes to reflect any changes to the initial target market assessment to take into account the specific sustainability-related amendments to the MiFID II DD and additional points reflected in the ESMA CP.

29. See amended ICMA2 Schedule 1 (*"Retail investor target market assessment using ESMA categories"*) published by ICMA on 5 October 2022 to reflect the amendments to the MiFID II DD and the ESMA CP.

[4] In accordance with the original parameters for Base case 'A', only to the extent that such bonds do not incorporate any features that would make them ESMA complex.

[5] In accordance with the original parameters for Base case 'A', i.e. whilst technically ESMA complex, there are no additional risks that are difficult to understand.