ICMA continues to focus on implementation of the MiFID II/R product governance (PG) and PRIIPs regimes ahead of their coming into effect in January 2018 and following ESMA’s publication of its Final Report: Guidelines on MiFID II Product Governance Requirements. In July were published a PRIIPs Communication by the European Commission and PRIIPs Q&A (on KID content) by the ESAs. There may be further guidance during the summer.

**Legal basis**

The PG regime’s basis is so far in (i) MiFID II Arts. 16.3/24.2 (and related Recital 71) at Level 1, (ii) MiFID II Delegated Directive 2017/593 Arts. 9/10 (and related Recitals 15-20) at Level 2 and (iii) the above ESMA final Guidelines at Level 3.

**Concept**

ICMA is working on the assumption that underwriters of new bond issues may be product “manufacturers” (as broadly “advising corporate issuers on the launch of new financial instruments”) in addition to being initial “distributors” (involved in offering/recommending/selling). As manufacturers, they must from 2018 have processes to (i) define (and communicate to subsequent “distributors”) “positive”/compatible “target markets” (TMs – involving specified criteria) as well any “negative”/incompatible investor groups and (ii) periodically review these TMs in light of any feedback from distributors (bearing in mind the ESMA final Guidelines envisage distributors only refining rather than widening manufacturer TMs). Underwriters must also have TM definition/review processes as “distributors” (though they can rely on their manufacturer TM work in this respect). The “proportionate” application of these requirements is heavily emphasised.

**Need for harmonised market practice**

The main ICMA focus is on the, overwhelmingly wholesale, international bond markets that borrowing businesses currently depend on to swiftly and efficiently fund much of their real economy investments (often on an intra-day basis that minimises market risk) – a key plank of Europe’s CMU initiative. ICMA’s aim is to develop one or more “harmonised” market-wide PG practices, that will enable such borrowers to access the markets directly without needing to await lengthy preliminary PG consensus deliberations among the multi-bank underwriter syndicate groups that borrowers put together for each transaction. Transaction parties can of course choose to apply alternative “bespoke” PG practices involving such deliberations, but will need to allow for significantly longer transaction timelines in order to develop them.

**Professional investors TM**

The simplest harmonised practice that seems deliverable by 2018 is an “all bonds/all professionals” proportionate TM practice. On the basis that professional investors possess the experience, knowledge and expertise to define their needs and objectives, make their own investment decisions and properly assess and manage the risks/returns that they incur (as acknowledged in Annex II of MiFID II), they should be able to buy and hold any investment, regardless of product type or the nature of the issuer/borrower, and therefore the “manufacturer” of a bond instrument should have complied with the product governance regime if it ensures that measures are put in place on issue that are reasonably expected to result in sales only being made to such professional investors.

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46 This odd-looking extension follows from the fact that, unlike the PRIIPs regime, the PG regime does not bind most issuers/borrowers who, being non-financial, are not MiFID entities.

47 Though this remains subject to occasional “suitability” assessments specific to individual investors outside the TM.
investors in the EEA. Such measure will likely include primary market selling restrictions (probably similar to the forms of restrictions that have begun emerging in bond programme prospectus updates in relation to PRIIPs) and legends warning of the investor base limitations - and represent a consistent approach across the MiFID II, PRIIPs and prospectus regimes. Advantages of this TM approach include:

- that its rationale is likely to endure over time and so is particularly conducive to adoption as a harmonised market-wide approach (as well as providing certainty in terms of periodic TM reviews); and
- from a PRIIPs perspective, it should efficiently avoid borrowers (as PRIIPs manufacturers) having to publish a key information document (KID - the potential civil liability for which is not expected to be acceptable to borrowers).

**Retail investors TM**

The scope for a 2018 delivery of a harmonised market-wide PG practice(s) involving retail investors (other than via discretionary managers who are professionals) seems more challenging, with several options being considered. In the case of delivery of no, or limited, harmonised practice(s), borrowers might need to fall back to bespoke practices to access retail investors - which they may well be unlikely to do given the transaction timeline implications. This compounds the continuing concerns over open-ended ambiguity of PRIIPs’ “packaged” product scope (highlighted in prior PRIIPs coverage in this Quarterly Report). In any case, it seems direct retail investor participation in the international bond markets will be further curtailed. This seems to be acknowledged by the Summary of CMU Mid-Term Review consultation responses that states: “[...] some respondents stated that the costs and burdens for providing investment services have dramatically increased as a result of new regulations and that they may constitute a barrier to selling products to retail investors. This is primarily affecting the sale of simple products, as [...] bonds are more and more submitted to stricter rules. PRIIPs and MiFID II product governance regimes will reduce the availability of [...] simple bonds to retail investors.”

**Regulated Market (RM) admission not per se retail**

It is worth noting in the context of the above that purely wholesale bonds are admitted to Regulated Markets. In this respect, RM admission should not equate per se to targeting of, or (for PRIIPs purposes) making available to, retail investors. To decree otherwise would be inconsistent with:

- public policy/CMU objectives: RMs have historically operated (and this continues in the goals of CMU) on the basis that they should include a wide and deep spectrum of investment choice; such variety is enabled, and users and suppliers of capital are encouraged to participate, because RMs bring the highest levels of initial (Prospectus Directive), ongoing periodic (Transparency Directive) and ad hoc (Market Abuse Regulation) disclosure, and so consequent investor protection; attaching PG/PRIIPs retail consequences would involve a significant risk that RMs (and their related protections) reduce in terms of size/range;

- investor protection objectives: notably, ESMA has stated that only professional investors have the skill and resource set to analyse contingent convertibles instruments (CoCos), whilst producing KIDs would seem to facilitate their sale to retail investors;


**Other aspects of product governance**

In terms of other aspects, ICMA is considering:

- the application of the PG regime outside Europe (with particular focus on the proportionality of following the requirements of local law);

- whether any negative TM would be applicable for bonds, inter alia given, in the absence of regulators exercising their product intervention powers, portfolio/diversification considerations;

- the status of legacy bonds (“manufactured”/issued prior to 2018) for which there is no grandfathering in respect of ongoing distributor TM or manufacturer reviews (query whether defaulting to the above “all bonds/all professionals” TM practice absent specific indication otherwise may be the least disruptive option);

- distribution of responsibilities between co-manufacturers (lead-managers, co-managers and MiFID entity issuers).

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