ICMA
International Capital Market Association

Retail Distribution Policy
Strategy & Competition
Financial Conduct Authority
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(Submitted by e-mail to PRIIPsCfI@fca.org.uk)

28 September 2018

Dear Sirs,

FCA Call for Input: PRIIPs Regulation – initial experiences with the new requirements

The International Capital Market Association (ICMA) welcomes the opportunity to provide input on the PRIIPs Regulation by responding to the FCA Call for Input (CFI).

Representing a broad range of capital market interests including banks, asset managers, exchanges, central banks, law firms and other professional advisers, ICMA's market conventions and standards have been the pillars of the international debt market for almost 50 years. See: www.icmagroup.org.

ICMA's comments are given in relation to its primary market constituency of underwriters that lead-manages syndicated debt securities issues throughout Europe. This constituency deliberates principally through ICMA's Primary Market Practices Committee[1] , which gathers the heads and senior members of the syndicate desks of 50 ICMA member banks, and ICMA's Legal and Documentation Committee[2], which gathers the heads and senior members of the legal transaction management teams of 21 ICMA member banks, in each case active in lead-managing syndicated debt securities issues in Europe.

We set out our input in the Annex to this letter and would be pleased to discuss it with you at your convenience.

Yours faithfully,

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[1] http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/Primary-Market-Practices-Sub-committee/.

[2] http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/Legal-and-Documentation-Sub-committee/.

Annex
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Input

Introduction & executive summary

1. **Introduction** – Underwriters manage new ‘vanilla’ bond issues for their issuer/borrower clients on a daily basis and so have significant visibility over the impact of new regulations on bond issuance. In this respect, ICMA has been focusing on and engaging in the PRIIPs debate for over a decade.[3] This input addresses Questions 1-3, 5, 7 and 9, where ICMA is best able to provide a meaningful contribution at the trade association’s collective/‘street’ level. This input also addresses a few other pertinent aspects.

2. **Executive summary**

   (a) **PRIIPs product scope** – The product scope of the PRIIPs regime has been confusing in practice. It seems to have been interpreted by some as wider than initially expected, e.g. to include some vanilla bonds. This needs to be rectified given the potential sanctions for PRIIPs availability to EEA retail investors without a KID and the apparent consequential avoidance of retail investors by many borrowers. In this respect, the ESAs’ granular scope clarification suggestions are helpful – for example that make-whole features are not ‘packaging’ if the discount rate *“mechanism”* is known in advance (so including where this involves observation of a specified value at a specified time). To the extent a conceptual, rather than a granular, approach to scope clarification is desired, some draft wording is suggested.

   (b) **KID content** – Challenges within the KID include the following: (i) vanilla bonds involve no costs & charges, (ii) the synthetic risk indicator involves seemingly arbitrarily weighted components and (iii) the prescribed performance scenario methodology seems flawed, potentially misleading and needs to be amended.

   (c) **KID concept** – The clear purpose of short-form disclosure should be as a quick first point of information and not as the basis for an informed investment decision. However, the vague position under the PRIIPs regime raises civil liability risk to the point of undermining a borrower’s certainty of funding (i.e. confidence that the borrowed amount can be used for the whole bond term) – certainly for investment grade benchmark-funding borrowers in the international markets (which consequently prefer to avoid retail investors unless they are clearly outside the product scope of PRIIPs).

   (d) **Other aspects** – One should recall that there are non-PRIIPs regulatory, as well as non-regulatory, disincentives to retail supply. Also, in attempting to promote direct retail access to investments, one should not disrupt EEA wholesale funding markets that are crucial for the economy. Lastly, there are a couple of apparent inaccuracies in the CFI’s footnote 3 and paragraph 2.1.

[3] Continuously since ICMA participated in the Joint Associations Committee January 2008 response to the European Commission’s October 2007 call for evidence on substitute retail investment products. See further ICMA’s Initial disclosure (Prospectus and PRIIPs) webpage.

PRIIPs product scope

Q1: Are you experiencing problems with clarifying the scope of the PRIIPs Regulation? Please provide examples of product types where you believe there is uncertainty as to whether they are in scope.

Q2: Have you tried to resolve this uncertainty and faced difficulties in doing so? If so, please provide details and examples of the difficulties you have faced.

3. **Initial expectation of vanilla exclusion from scope** – Industry had expected vanilla bonds (those with a fixed rate, floating rate or zero coupon) to be outside the scope of the PRIIPs regime, given (a) the regime's origin in the *"substitute retail investment products"* initiative relating to UCIT funds[4] and then (b) the amount received from, and thus arguably *"repayable"* to, an investor in such bonds not being *"subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor"*. This latter basis in the PRIIPs L1 Regulation's Article 4(1) operative definition is consistent with the Regulation's recitals in that (i) vanilla bonds do not *"intercede between the retail investor and the markets through a process of packaging or wrapping"* and (ii) *"deposits solely exposed to interest rates"* and *"Assets that are held directly, such as corporate shares or sovereign bonds"* are explicitly stated as being out of scope.

4. **Confusing extraneous official statements** – However, various extraneous and inconsistent official public statements[5] have since put this in doubt. As of late 2016 ICMA reported[6] *"[…] there currently seems to be a market consensus that basic fixed or floating rate notes are not PRIIPs and that features such as an exotic currency, a guarantee, a put or a call would not, on their own, result in such securities being characterised as PRIIPs (to the extent made available to retail investors). However, consensus in relation to other vanilla debt securities may take some time to emerge."*

5. **Consequential borrower caution** – Given this uncertainty and the significant sanctions for making PRIIPs *"available"* to retail investors in the EEA without a KID (a fine of €5 million or 3% of annual turnover), borrowers are likely to be advised to err on the side of caution if in doubt as to whether a product will be seen as a PRIIP by any of the 28 EU Member State regulators given PRIIPs responsibility at the national level (the Regulation does not provide for single-regulator jurisdiction per individual PRIIP[7]). In this respect, the 19 July ESAs' letter to the European Commission[8] noted *"analysis in some Member States indicating that there has been more than a 60% reduction in the number and overall volume of low denomination issuances by nonfinancial corporates in the first quarter of 2018 compared to the first quarter of 2017"*. This is consistent with ICMA's initial findings reported in the ICMA Quarterly Report.[9] ICMA's subsequent full first half 2018 findings (on the same basis) seem to indicate a 30%-40% decline in low denomination

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[4] Mentioned in #14.

[5] Notably: (i) *"**Convertible** bonds […] In scope"* (ESMA 2014 DP, p.13); (ii) *"if […] performance **caps** and/or their return is linked in a **non-linear** way with the underlying interest rate, then they are in scope"* (ESMA 2014 DP, p.14); (iii) PRIIPs rules *"are a response to a myriad of problems that retail investors faced in the past. For example, a consumer Ombudsman in one Member State recently found 12-year **subordinated** notes […]"* (EC 2014 press release); (iv) *"**SPVs** (instruments issued by) […] In scope"* (albeit AIFMD/Solvency II context) (ESMA 2014 DP, p.14); (v) potential KID risk indicator classification options including *"**perpetual**"* notes/instruments (ESMA 2015 DP, pp.35/36) (though query causality). This was also flagged in ICMA's *January 2018: An approach for the Eurobond markets* draft paper (referred to as "ICMA1") developed in relation to the implementation of the PRIIPs and MiFID II product governance regimes.

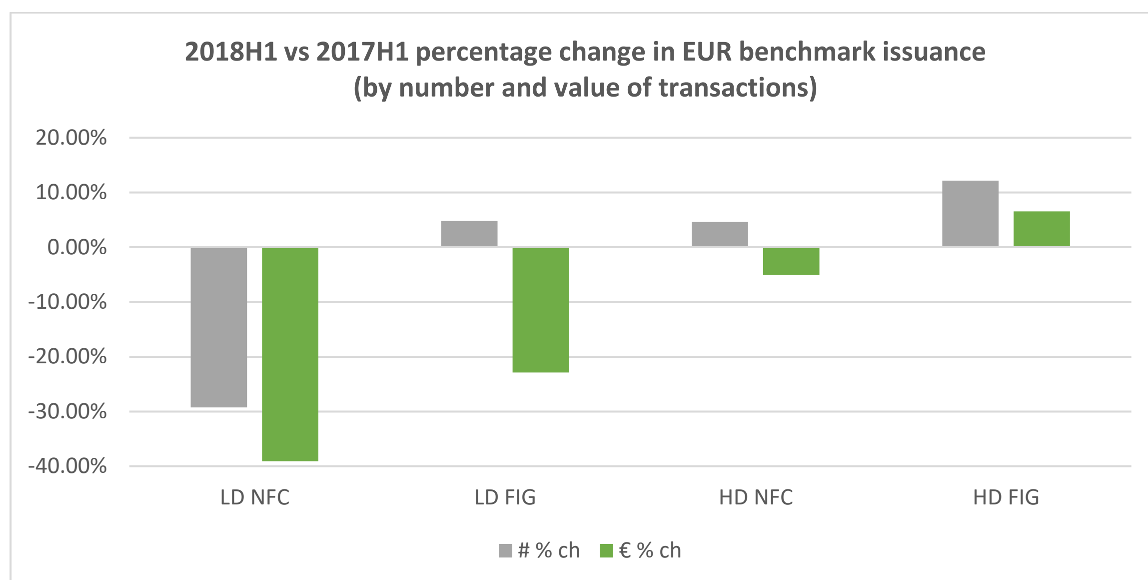
[6] ICMA Quarterly Report, Fourth Quarter 2016, p.26.

[7] Article 5.8 of the PRIIPs L1 Regulation defines 'competent authorities' just as the national authorities designated by a Member State to supervise the requirements this Regulation places on PRIIP manufacturers and the persons advising on, or selling, the PRIIP. Article 8.3(a) of the Regulation requires the KID to state *"information about the competent authority of the PRIIP manufacturer"* – but that seems to reference MiFID-like general supervisory authority rather than PRIIPs jurisdiction.

[8] 19 July 2018 letter on *Implications of the uncertainty as to the scope of the PRIIPs Regulation (1286/2014) and request for Commission guidance*.

[9] Second Quarter 2018 edition at pages 28-29.

non-financial corporate (LD NFC) issuance, in contrast to high denomination (HD) and financial institution (FIG) issuance – see chart below. This recent decline comes on the back of a long-term decline in low-denomination bonds over the past 15 years, originally driven by the EU Prospectus Directive's low denomination regime.



Source: ICMA/Dealogic

6. **ESAs' granular scope clarification suggestions** – The 19 July ESAs' letter lays out some helpful and granular scope clarification suggestions. For example, the ESAs' letter seems to indicate that 'make-whole' call features, which protects investors by compensating them for potential loss of future earnings when issuers to repay bonds early[10], should not be 'packaged' if the *"mechanism"* to calculate the discount rate is known in advance. This would seem to cover the mechanism (customary in the bond markets) that prescribes observation of a specified value (such as a particular government bond) at a specified time (when the issuer chooses to repay) to calculate the discount rate. European Commission endorsement of the ESAs' suggestions seems to be needed so that they can be relied on in practice.[11] It is in any case useful that the ESAs' letter officially confirms that the PRIIPs L2 Regulation was drafted just for *"packaged or wrapped products"* according to Recitals 6 and 7 of the PRIIPs L1 Regulation and not for *"non-structured bonds"*.

7. **Alternative conceptual scope clarification approach** – Set out in the shaded box below is draft wording for potential adoption as official guidance if a conceptual approach to scope clarification is desired rather than a granular approach (as exemplified by the ESAs' suggestions above). Several large law firms active in the field of vanilla bond issuance believe such conceptual guidance would significantly facilitate legal advisers' ability to advise their borrower clients that vanilla bonds are outside the PRIIPs regime's product scope.

<< Article 4(1) of the PRIIPs Regulation states that a packaged retail investment product:
"means an investment […] where […] the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor".

[10] On the assumption investors would re-invest the money repaid at least in a low-risk investment such as a government bond, the aim is to compensate them for any extra interest that the repaid bond would have paid over and above the interest paid by the government bond.
[11] The ESA letter states *"As this is a matter concerning the legal interpretation of the Level 1 text that goes beyond its consistent and effective application, the ESAs are of the view that it is not appropriate to address this issue through an ESA measure."*

This Article should be read exclusively in the context of Recital 6 of the PRIIPs Regulation that states (underlining added for emphasis):

"For all those products," – i.e. where the amount repayable is subject to fluctuation or to the performance of non-purchased assets as noted above – *"investments are not of the direct kind that is achieved when buying or holding assets themselves. Instead these products intercede between the retail investor and the markets through a process of packaging or wrapping together assets so as to create different exposures, provide different product features, or achieve different cost structures as compared with a direct holding."*

In this respect, *"reference values"* relates to creating synthetic exposures through proprietary benchmarks. >>

KID content

8. **General** – Generally, and since the PRIIPs KID regime has been challenging in terms of both scope (as noted above) and concept (as noted below) regardless of the KID's specifically prescribed information items, there is unsurprisingly limited experience[12] and thus limited feedback so far on individual information items.

Q3: Have any of your calculations of transaction costs under the slippage methodology led to negative, zero or unexpectedly large transaction costs? If so, please provide examples, together with the full calculation of how the output has been obtained, and explaining any assumptions that have been made.

9. **Cost & charges** –Vanilla bonds simply pay a fixed or floating rate of interest with no costs (as noted in prior ICMA material[13]). Though the ESAs have now confirmed they did not intend to cover vanilla bonds in their drafting of the PRIIPs L2 Regulation[14], a KID costs section for a vanilla bond (with a make-whole call) indicated costs of zero (in cash and percentage terms).

Q5: Please provide your views, supported by evidence, on the SRI and on the extent to which the required and optional sections of the risk narratives enable the risks of a product to be adequately explained to consumers.

10. **Synthetic risk indicator** – The synthetic risk indicator (SRI) seems to be conceptually challenging to the extent it purports to blend different risk elements into a single linear measure – which involves seemingly arbitrary weighting of the individual component elements. See further ICMA 2015 commentary[15] on the 'single' risk indicator concept.

Q7: Have you experienced any practical issues with the calculation and presentation of performance scenarios in the KID? If so, please provide details so that we can identify any further practical difficulties not fully contemplated in our statement of January 2018.

11. **Performance scenarios**

    (a) From a pragmatic perspective, manufacturers face the challenge of ensuring sufficient and clear qualifying narrative information is either included within the KID's three-page length

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[12] There are currently no known KIDs for 'benchmark' bond issues above €500 million in size.

[13] ICMA August 2015 response to the ESAs' Discussion Paper JC/DP/2014/02, paragraph 23.

[14] As noted in #6.

[15] ICMA August 2015 response to the ESAs' Discussion Paper JC/DP/2014/02, paragraphs 6 and 10.

limit or otherwise sufficiently 'attached' to defeat any civil liability claim for misleading representation.[16] Fundamentally, the L2 Regulation methodology requires amendment.

(b) Though the ESAs have now confirmed they did not intend to cover vanilla bonds in their drafting the PRIIPs L2 Regulation[17], a KID performance scenario for a vanilla bond (with a make-whole call) indicated that in a favourable scenario £10,000 invested over the bond's 5½ year term could return £17,600. Yet even if one assumes interest is compounded over the term (which it is not), the £10,000 invested would return just over £13,000. In this respect the KID stated: *"Due to the way the calculations must be carried out, and owing to the nature of a fixed income paying bond, certain performance scenario information appears overly optimistic and may be misleading."* It is worth noting that ultimately a vanilla bond's ordinary course 'performance'[18] is just repayment of principal and payment of the contracted interest.

The KID concept

Q9: Are there any other experiences with the implementation of (and compliance with) the PRIIPs legislation that you wish to raise with us? Please include evidence to support the points you make.

12. **Background** – There has been is a complex and long running debate around the circumstances of retail participation in financial markets[19] – including around actual and perceived mis-selling, regulator supervision of retail intermediaries and retail-facing disclosure (such as prospectuses and KIDs).

13. **KID purpose fundamentally important** – A short document being intrinsically ill-suited to set out all information material to an investment decision and at risk of being misunderstood in any case, it would consequently seem that a KID should have been established as *"as a quick first point of comparison before seeking more detailed information[20] (in the case of the more sophisticated) or as a good introduction to the [relevant product] and a means of arming themselves with questions to ask a financial advisor (for the least sophisticated)"*. Such a KID purpose was something the 2009 UCITs findings[21] noted *"consumers at all levels of financial sophistication and investment experience felt that they would benefit from using"*. However, this does not seem to have been achieved by the vague expression of the KID's purpose that arises between Articles 1 and 8(2) and Recitals 15, 22 and 26 of the PRIIPs L1 Regulation. For example, senior ESMA staff seem to have perceived[22] the KID's purpose as being inter alia to *"contain sufficient information to allow consumers to make an informed investment decision"* (and this is required on a continuous basis during the product's vague retail 'availability'[23] rather than just at the point of initial offering or stock exchange admission).

[16] ICMA's August 2015 response to the ESAs' Discussion Paper JC/DP/2014/02 noted *"Many of the options discussed in this DP involve estimations and/or assumptions, and it is unclear whether any accompanying narrative will adequately address any potential for investors to be misled (especially given KID space constraints)"*. The response also flagged other considerations around performance scenarios (at paragraphs 7/8, 20/21 and 22/11). The FCA's 24 January 2018 *Statement on communications in relation to PRIIPs* (further to initial press cover) sets out a practically helpful element of certainty for consequential conduct regarding information perceived as *"too optimistic, such that they may mislead investors"* – but the inclusion/'attachment' point remains.

[17] As noted in #6.

[18] That is, on the basis that its terms are honoured in practice.

[19] And see further #16 regarding the CMU aspects.

[20] Such as a prospectus under the Prospectus Directive.

[21] 2009 UCITS Disclosure Testing Research Report.

[22] October 2014 Steven Maijoor speech.

[23] And see #18.

14. **Credit and the risk of misleading by omission** – Though development of the PRIIPs regime was originally (in the context of 'substitute retail investment products' in relation to UCITs) focused on demystifying 'packaging'[24], the PRIIPs KID ended up being subject to an explicit requirement for borrower credit risk disclosure (as part of the 'SRI' summary risk indicator). Combined with the KID's three-page length cap, this seems to make it practically impossible to disclose the borrower's credit 'story' without radically simplifying it and so risk failing to include *"sufficient information"* for an *"informed investment decision"*.

15. **Consequent liability risk incompatible with borrowers' certainty of funding** – The above would create a de facto investor put: an effective right for investors to claim reimbursement (and perhaps compensatory damages) on all borrowings at any time – which is fundamentally incompatible with, notably, corporate borrowers' need for certainty of funding (i.e. confidence that the borrowed amount can be used for the whole bond term). This is fundamental as borrowers cannot simply liquidate half-built factories to repay e.g. €500 million or €1 billion borrowings ahead of schedule. The PRIIPs Regulation includes a cap on civil liability[25], but this is of limited relevance since:

    (a) it does not seem to apply where (i) a KID is individually misleading even if the KID is otherwise accurate and consistent with a full prospectus[26] or (ii) a KID fails to comply exactly with the PRIIPs Regulation's specific disclosure requirements (which are subject to controversy as noted in the CFI); and

    (b) its geographic scope is restricted to the EEA – and the, typically larger, borrowers active in the bond markets have worldwide economic exposure, including in the US.

    The practical impact of this civil liability risk may be lessened in the context of (i) small-sized transactions relative to a borrower's balance sheet size (e.g. €10 million), (ii) integrated distribution dynamics (where there is no active independent secondary market and any ongoing trading involves the borrower or entities it is in contact with for this purpose) and (iii) domestic-only (and so likely smaller sized) borrowers located in jurisdictions with less active civil liability traditions. Of course, some borrowers have no other funding alternatives and have no choice but to take the risk of producing a KID. This is not the case for investment grade benchmark-funding borrowers in the international markets, which consequently prefer to avoid retail investors[27] rather than produce a KID (unless they are clearly outside the regime product's scope[28]).

Other aspects

16. **Non-PRIIPs challenges to direct retail bond market participation** – There are various non-PRIIPs regulatory challenges to direct retail bond market participation, notably the recent MiFID II product governance regime, the Prospectus Directive low-denomination regime[29] and national consumer rules[30]. ICMA has published two draft papers setting out challenges and potential

[24] See further #3 on initial scope expectations.

[25] Article 11.1 of the PRIIPs L1 Regulation states there will be no civil liability solely based on the KID *"unless it is misleading, inaccurate or inconsistent with the relevant parts of legally binding precontractual and contractual documents or with the [specific disclosure] requirements laid down in Article 8."*

[26] In contrast to the Prospectus Directive's provisions on liability attaching to a prospectus summary.

[27] As noted in #5.

[28] As discussed above in the responses to Q1 and Q2.

[29] And see #5 regarding the long-term decline in low-denomination bonds over the past 15 years.

[30] For example, the extension in Belgium of the Unfair Contract Terms Directive to financial contracts per Belgium's FSMA Position FSMA_2017_04 of 30/01/2017.

approaches relating to product governance (as well as PRIIPs).[31] Some of the other challenges (and some potential solutions) were discussed in an ICMA 2015 paper on CMU (PRIIPs was also discussed).[32] There are also non-regulatory challenges to retail supply, notably small ticket new issue distribution & liability management logistics, public profile and related reputational/litigation considerations – these were also discussed in the ICMA 2015 paper.[33]

17. **Wholesale market protection** – It is also worth bearing in mind that whatever steps are taken in an attempt to minimise retail market disincentives, care also needs to be taken not to disrupt the institutional/wholesale markets which have been reliably providing trillions in financing to the EU's economy over the years. In this respect, the Prospectus Directive's alleviated high denomination regime has at least enabled wholesale market activity to continue in the EEA, which should not be taken for granted[34] as many borrowers find the PD's low denomination disclosure regime (in particular the need for a summary) too burdensome[35]. (Removing this high denomination regime, rather than encouraging EEA retail offerings, would involve *"a risk [of] a shift of new listings of debt securities from regulated markets towards multilateral trading facilities, as the Directive does not apply to the admission to trading on these venues."*[36])

18. **Specific points arising in the CFI** – Footnote 3 and paragraph 2.1 of the CFI states the MiFID II 'manufacturer' definition as having been applied by the UK in the PRIIPs Regulation context. This is not strictly accurate, as the UK's PRIIPs provisions actually reference the PRIIPs L1 Regulation's provisions and not the UK's implementation of MiFID II. Distinctly, paragraph 2.1 of the CFI references just an EEA retail *"offering"*, though the vaguer *"making available"* is more relevant given its perceived wider ambit. Also, in terms of *"disclosure"* frameworks cited in Table 1, MiFID II rules for *"distributors"* are cited but disclosure rules for borrowers (Prospectus Directive, Transparency Directive and Market Abuse Regulation) are not.

Conclusion

19. It is essential to recall that EU policy intent supports direct retail access to the bond markets (as articulated in the context of CMU[37]), and presumably not only indirectly via collective holding vehicles or discretionary management. In this respect one must ensure the related regulatory regimes deliver the desired outcome. ICMA would be happy to assist the FCA further in this respect. Given the Eurobond markets' cross-border nature, any post-Brexit[38] UK developments would have limited impact beyond the purely domestic context (other than by way of potential precedent for other jurisdictions).

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[31] ICMA *January 2018: An approach for the Eurobond markets* draft paper (referred to as "ICMA1") and related *Retail bonds (admitted to trading on an EEA regulated market) – 'ICMA2'* paper.

[32] 30 April 2015 response to the European Commission's *Green Paper on Building a Capital Markets Union*, at paragraphs 98-100 and 102 at pages 17-19.

[33] At paragraphs 14 on p.3 and then paragraphs 92-97 at pages 16-17.

[34] Harvard Law School Forum on Corporate Governance and Financial Regulation 6 November 2016 The New EU Market Abuse Regulation: Impact on US Issuers: *"We understand that some bond issuers are choosing to list bonds on stock exchanges not subject to MAR (e.g the Channel Islands Securities Exchange) to avoid MAR application."*

[35] And see #5 regarding the long-term decline in low-denomination bonds over the past 15 years.

[36] European Commission November 2015 Prospectus Regulation Impact Assessment (at p.32).

[37] Most recently, the 19 July ESAs' letter states *"CMU aims, amongst other things, at increasing direct retail investment within the capital markets."*

[38] The CFI notes a feedback statement is only to be expected in *"early 2019"*.