ICMA

International Capital Market Association

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ICMA response to UK FCA Consultation Paper CP21/36

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A new Consumer Duty

Feedback to CP21/13 and further consultation

Key points

The FCA's general intention to exclude vanilla bonds from the scope of the new consumer duty is welcome, as some investor protection measures do not properly address 'flow' securities markets and have diminished borrowers' appetite to offer bonds to retail investors bonds. But the *"non-complex financial instrument"* exclusion seems likely to be of only marginal relevance in this respect, notably given its limitation to bonds that are *"regularly traded"* (a very narrow concept as defined) - as well as only being issued by 'real economy' borrowers. It should be consequently widened.

The FCA's general intention to exclude institutional/wholesale bond markets from the scope of the new consumer duty is welcome, as these have been reliably providing trillions in financing to Europe's economy over the years and care needs to be taken not to disrupt them. But the "*non-retail financial instrument*" exclusion does not seem to achieve this, notably given its limitation to bonds with a denomination of GBP 100k or more (or equivalent) when USD/EUR institutional issuance (largely in USD/EUR 100k denominations - i.e. around GBP 70-80k) represents over 79%/91% of overall issuance in number/volume terms. The minimum denomination requirement should be calibrated to GBP 50k and (consistently with the Prospectus Regime) also be alternative to the eligible investor requirement.

Distinctly, pre-existing bonds should be grandfathered in terms of ongoing obligations (to avoid retrospective regulation).

<u>Introduction</u>

1. **Scope of response** – ICMA is responding to current CP21/36 from the perspective of the international bond primary markets and only to Q1 - *Do you have any comments on the proposed scope of the Consumer Duty?*. However, ICMA also notes in passing that the proposed nine-month implementation period following final rule publication (as noted in #43 of current CP21/36)[1] seems very short given what is involved and also is materially shorter than the specific timelines cited in industry responses to prior CP21/13 (ranging from one to three years according to #13.3 of current CP21/35). Lastly, this response also opportunistically flags, under #9 below, a related aspect arising in CP22/2.

[1] And seemingly consistent with the combination of (i) #13.11 noting firms having until 30 April 2023 and (ii) the editor's note on page 9 of 51 of the Draft Handbook text in Appendix 1 noting amendments coming into force on 29 July 2022 / the FCA 7 December 2021 press release noting FCA expects to confirm any final rules by the end of July 2022.

'Vanilla' retail bonds

2. **Background** – Some investor protection measures created and/or expanded in the context of 'services' being rendered to investors do not properly address 'flow' securities markets: ICMA has repeatedly stated that MiFID's product governance regime is conceptually flawed regarding commoditised funding products such as Eurobonds that are not 'designed' as a 'service' for investor 'clients'. Rather, bonds have been in existence for decades as a 'product' for corporate and other borrowers to seek funding from the markets. Furthermore, the product governance regime has in practice (in combination particularly with the PRIIPs regime and also partly with the Prospectus regime's retail disclosure requirements) further diminished borrowers' appetite to offer bonds to retail investors.

3. **Exclusion needed** – In this respect (and assuming the UK authorities wish to foster the potential for an active retail bond market in the UK[2]), there is a need to exclude vanilla bonds from the scope of the new consumer duty and so ICMA agrees with the FCA's general intention stated in #3.28 of the consultation.

4. **Proposed exclusion too narrow** – However the specifics of the *"non-complex financial instrument"* exclusion (given effect via draft PRIN 3.2.6 R) are that such instruments (i) be *"regularly traded" on a UK exchange*, (ii) have public *"adequately comprehensive information on its characteristics [that] is likely to be readily understood so as to enable the average retail client to make an informed judgment as to whether to enter into a transaction in that instrument"*, (iii) be a *"real economy security"* and (iv) not be a *"speculative illiquid security"*. This is too narrow in several respects and should be widened or risk retail bond markets excluding UK investor participation.

   (A) The requirement to be ***"regularly traded" on a UK exchange*** involves a case-by-case assessment, even where there is a dedicated market maker[3] (something that, outside the historic UK retail ORB context, is very rare in the international bond markets that are mainly institutional and likely to remain that way given current prudential regimes). The natural market liquidity of individual bonds can evolve significantly over time: very liquid when 'on the run' (particularly following issuance and ahead of redemption and material corporate actions) and much less liquid at other times. But it is not feasible for market practitioners to treat an individual bond as falling outside the consumer duty at certain times but not at other times. Bond issuers and their advisers (when conducting regulated activities in the UK[4]) will be looking to make a binary choice on issue that will last for the life of the bond (for reasons of logistical efficiency and regulatory robustness). Since being subject to the consumer duty is not a realistic option (as noted under #2 above), the outcome would be for bonds to be limited to the institutional investor context only (which is separately addressed under the *Institutional bonds* heading below) and so not helping any UK policy objective to help retail access to capital markets. Also bonds in the mainstream public markets tend to be listed on a range of stock exchanges internationally of repute – just one of which is in the UK. And in any case bond trading (at least in the institutional space, outside the historic UK retail ORB context) has tended to be OTC (off-exchange), with an increasing element traded on MTFs

[2] See ICMA response to HM Treasury Wholesale Markets Review (questions 103-105 relating to UK authorities playing a role to facilitate retail access to capital markets).

[3] See FCA Policy Statement PS20/15, page 14. ICMA had originally expected (in the context of its response to FCA Consultation Paper CP20/8 on speculative illiquid securities) that FCA intended the concept of "not regularly traded" to capture securities with no 'natural' trading market (notably for example where only the originator/issuer of the securities and/or connected parties would trade, with no third-party interest at all) – rather than to capture merely infrequently traded securities.

[4] See #3.37 of the consultation.

and OTFs (platforms). So the range of bonds satisfying this requirement seems likely to be marginal.

(B) The subjective requirement to have public *"**adequately comprehensive information** on its characteristics [that] is **likely to be readily understood** so as to enable the average retail client **to make an informed judgment** as to whether to enter into a transaction in that instrument"* should be satisfied by the existing objective Prospectus Regulation regime requirements: a retail prospectus is required to *"contain the necessary information which is material to an investor for making an informed assessment"* and to be *"in an easily analysable, concise and comprehensible form"*[5] and approved by the FCA.

(C) The requirement to be a ***"real economy security"*** notably involves *"the level of any interest payable, the issuer's default risk, and any fluctuations in the market value of the security are wholly or predominantly determined by the actual or anticipated economic performance of the commercial or industrial activities of the issuer [or group guarantor]"* (excluding any financial sector activities such as lending / investment). This would seem to eliminate even senior preferred bonds from financial borrowers. It could also be interpreted to exclude official sector bonds issued by very highly-rated supra-national lenders, which have often allowed for retail participation. Query even whether a government bond might be excluded if its exposure is not seen to be based on that government's "*commercial or industrial activities*". (The related requirement to not be a ***"speculative illiquid security"*** may also be problematic in this respect.)

It is unclear whether the additional requirement that there be **no additional derivative / conditionality / structuring** might be problematic or not – much will depend on specifics as has been illustrated by the controversy surrounding the scope of the PRIIPs regime.[6]

(D) These requirements were covered in the FCA's Consultation Paper CP20/8 on speculative illiquid securities, which ICMA responded to and noted FCA's subsequent conclusions. ICMA understands FCA's underlying concerns were driven by the apparent passporting into the UK of retail offerings of certain EU prospectus regime securities. However, the UK authorities could simply restrict such passporting following Brexit.

Institutional bonds

5. **Background** – Whatever steps are taken in an attempt to protect retail investors and/or promote retail markets, care needs to be taken not to disrupt the institutional/wholesale markets which have been reliably providing trillions in financing to Europe's economy over the years.

6. **Exclusion needed** – In this respect, there is a need to exclude institutional bonds from the scope of the new consumer duty and so ICMA agrees with the FCA's general intention stated in #3.28 of the consultation.

7. **Proposed exclusion too narrow** – However, the specifics of the *"non-retail financial instrument"* exclusion (given effect via draft PRIN 3.2.6 R) notably involve (i) marketing disclosure being clear the offer is for ECPs/professionals only / not intended for retail, (ii) reasonable steps by issuers (or *"distributors"* in secondary markets) to limit promotions to ECPs/professionals, (iii) GBP 100k minimum denominations/investment and (iv) not being a "speculative illiquid security". This is too narrow in several respects – similarly to what ICMA flagged in relation to the FCA's PRIIPs proposals[7] (hopefully this new consumer duty proposal is not front-running the still-pending

[5] Prospectus Regulation, Articles 6.1 and 6.2.
[6] See ICMA's most recent response to FCA Consultation Paper CP21/23 and response to the EU ESAs' Call for evidence on the European Commission mandate regarding the PRIIPs Regulation.
[7] See ICMA's most response to FCA Consultation Paper CP21/23.

conclusions relating to the FCA's PRIIPs proposal and to HMT's [Prospectus Regime Review consultation] that ICMA [responded] to, and FCA will be looking to adopt a consistent, evidence-based approach).

(A) The requirement, that *"in relation to secondary market offers,* ***the distributor****"* takes **reasonable steps** to limit promotions to ECPs/professionals, needs to be clearly understood to be limited to the ability of that *"distributor"* (and any connected parties) to treat the bonds concerned as excluded from the new consumer duty. It would be fundamentally unjust if a failure by one market participant caused a bond to generally lose its exclusion from the new consumer duty and unwittingly placed all other market participants in breach of the regime despite having no knowledge of or influence over that participant.

(B) The **cumulative nature of the ECP/professional and minimum denomination/investment requirements** reduces stakeholders' comfort perceptions and is inconsistent with the approach taken in related financial services regulation and therefore creates an incoherent rulebook, unnecessary complexity and costs for market participants. Broadly speaking, stakeholders are currently comfortable that, combined with some appropriate legending, the avoidance of retail-specific marketing and of direct retail access facilitation should be sufficient. The minimum denomination requirement and the eligible investor requirement should each just be alternative requirements to each other. This would also be consistent with the approach to exemptions from the UK's public offering rules that seem likely to be adopted further to HMT's Prospectus Regime Review consultation – where exemptions such as those related to minimum denominations and offers addressed solely to qualified investors are alternative rather than cumulative. There should be a consistent approach between the Consumer Duty, the PRIIPs regime and the Prospectus Regime.

(C) The **calibration of the minimum denomination at GBP 100k** (or equivalent in another currency) is very restrictive, bearing in mind [2021Q4 data] indicates USD/EUR institutional issuance represents over 79%/91% of overall issuance in number/volume terms (with GBP issuance being circa 5%) and being largely in USD/EUR 100k denominations (i.e. around GBP 70-80k) – so making the overwhelming majority of institutional bonds subject to retail consumer rules if they were to be traded in the UK. As noted in ICMA's response to HMT's Prospectus Regime Review consultation, the most straightforward way to handle this (assuming that it is not palatable to retain euro denominated thresholds in UK legislation) would be to reduce the threshold under the UK regime to GBP 50k or equivalent in alternative currencies – such that a bond with a minimum denomination of EUR 100k or USD 100k would satisfy the UK requirements. A GBP 50k minimum denomination exemption would still seem high enough to demarcate an issue as 'wholesale' rather than 'retail' and may in addition be perceived by institutional investors to be more attractive in terms of their ability to allocate bonds across their different portfolios. Here again there should be a consistent approach between the Consumer Duty, the PRIIPs regime and the Prospectus Regime.

(D) The requirement not to be a ***"speculative illiquid security"*** (broadly, a sub-GBP 100k denomination security with proceeds used for on-lending, investment or related to real-estate) (i) is superfluous to the currently cumulative nature of the ECP/professional and minimum denomination/investment requirements noted above and (ii) would be otherwise disproportionate in restricting the securities that ECPs/professionals can have access to (FCA have given no rationale in this respect and it would be strange to impose such an institutional restriction in a retail-focused initiative).

8. **Grandfathering of pre-existing bonds** – Presumably FCA intends event-driven obligations arising under the Consumer Duty to also apply in the context of securities (including bonds) that were issued prior to the Consumer Duty coming into effect. However, FCA does not presumably intend to impose retrospective regulations on manufacturers (or their advisers)

regarding products issued prior to the Consumer Duty coming into effect– as they have a legitimate expectation regarding their ongoing obligations unless they do something after the Consumer Duty comes into effect that falls within the scope of the Consumer Duty.

Financial promotion rules for high risk investments (CP22/2)

9. **Readily Realisable Securities description** – CP22/2 summarises (at p.15) Readily Realisable Securities (with no marketing restrictions) as including for example bonds traded on the London Stock Exchange. However, this is misleading due to the "regularly traded" requirement highlighted in #4(A) above, meaning many such bonds would not be treated as Readily Realisable Securities. (The actual proposals themselves seem however to be just about FCA looking to rationalise its nomenclature – with no substantive impact.)

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