The MiFID II product governance (PG) regime
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Retail bonds (admitted to trading on an EEA regulated market) – 'ICMA2'

Explanatory Note

Introduction

1. This paper seeks to recap on some currently anticipated retail approaches, in the syndicated/flow bond markets, to the PG regimes coming into effect from 2018. The approaches in this paper do not purport to be exhaustive or exclusive, but are anticipated to be useful to the extent transaction parties wish to minimise deal/syndicate-level deliberations, to maximise execution efficiency and speed (bearing in mind that many seasoned borrowers today are able to mandate a syndicate of underwriters to then price a benchmark-sized new issue within hours intra-day).

Background / PRIIPs

2. See further paper *The MiFID II product governance (PG) and Packaged retail investment and insurance products Regulation (PRIIPs) regimes - January 2018: An approach for the Eurobond markets (DRAFT RJDE 2017-12-21)* (the 'ICMA1 paper') for a brief background narrative to scope of the PG and PRIIPs regimes.

3. This paper does not address the PRIIPs regime, which needs to be separately satisfied in terms of any KID requirement. The ICMA1 paper includes some model PRIIPs-related wording. The PG approaches in this paper apply even where a KID is required (i.e. where a 'packaged' product is made available to EEA retail investors) and published.

Listed bonds

4. This paper relates to low-denomination[1] bonds admitted to trading ('listed') on an EEA regulated market, and so within the contemplation of the EU's related initial and ongoing transparency regimes[2] (or analogously subject to similar transparency).

5. MiFID II sets out the arrangements for supervision and operation of EEA regulated markets and for admission of securities to them. There are no restrictions on the type of issuer or credit that can be admitted (see Article 51). The operators of regulated markets have responsibility for ensuring compliance by issuers with their obligations resulting from admission, including those under the periodic transparency regime and ad hoc reporting under the market abuse regime (see Article 51(3)). The regime for suspension of securities from the market is only triggered by non-compliance with those obligations (see Article 52).

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[1] Commonly, but not only, €1,000 or equivalent - in contrast to high denomination bonds (most commonly today at least €100,000 or equivalent, though previously €50,000 or equivalent).

[2] Constituted by the Prospectus Directive (and in due course the Prospectus Regulation), Transparency Directive and Market Abuse Regulation, respectively in terms of initial, periodic and ad hoc transparency.

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

6. MiFID II further provides that bonds, other than those *"that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved"* (and which for MiFID II purposes, and the purposes of this paper, are known as "ESMA complex" bonds[3]), can be bought by retail investors on an execution-only basis outside the appropriateness regime.

7. The regulatory infrastructure therefore embeds two fundamental concepts: (a) provided the required disclosure is made, any security can be, and remain, admitted to a regulated market; and (b) any retail investor can buy or sell bonds that are not ESMA complex bonds on an execution-only basis without the benefit of intermediary protection under the appropriateness regime.

8. Given this, it is proportionate that a product manufacturer's responsibilities under the PG regime should be based on admission to a regulated market and the disclosure obligations consequent on it. All types of issuer or credit can be admitted provided proper disclosure is made. It follows that fluctuations in an issuer's credit profile during the life of the bond should not affect the target market assesment, provided the bonds concerned continue to be admitted to the regulated market, which will allow the product manufacturer to assume that the issuer is complying with the on-going disclosure obligations that permits such continued admission. In this respect, manufacturer target market reviews of the bond markets would logically conclude that no target market changes are warranted. In this respect, feedback from third party 'distributors' (in the specific PG sense) would be expected to be without impact on the (thus effectively 'enduring') target market assessment. The detailed target market identification (using ESMA categories) for this is set out in Schedule 1.

Variant 'B' – Certain ESMA complex bonds

9. ESMA complex bonds cannot be bought by retail investors on an execution-only basis outside the appropriateness regime.

10. However, certain ESMA complex bonds do not include terms that would affect the return expected from the product, that is the contractual right to return of principal consistent with, or more than, the original amount invested and, if applicable, a contractual right to regular payments of interest that are not deferrable. So, whilst technically ESMA complex, there are no additional risks that are difficult to understand. We refer to such bonds in this paper as "certain ESMA complex" bonds.

11. It is therefore proportionate that a product manufacturer's responsibilities under the PG regime regarding certain ESMA complex bonds should also be based on admission to a regulated market, the disclosure obligations consequent on it and a similarly enduring target market – albeit not on an execution-only basis outside the appropriateness

[3] See further ESMA's Final Report - *Guidelines on complex debt instruments and structured deposits* (ESMA/2015/1783).

regime. The detailed target market identification (using ESMA categories) for this is also set out in Schedule 1.

Variant 'C' – EEA-related official borrowers

12. The EU has as a matter of public policy exempted from its initial and periodic transparency regimes[4] non-equity securities issued by an EEA Member State or by one of a Member State's regional or local authorities, by public international bodies of which one or more Member States are members, by the European Central Bank or by the central banks of the Member States. It was noted[5] that Member States publish abundant information on their financial situation which is, in general, available in the public domain and that such information should not need to be provided in the prospectus. Given the connection with Member States of the other official bodies listed above, it follows that such information in their respect should not need to be provided in the prospectus either.

13. It is therefore proportionate that a product manufacturer's responsibilities under the PG regime regarding such official borrowers' bonds (being bonds that are not ESMA complex bonds or are only certain ESMA complex bonds) should again also be based on admission to a regulated market, the disclosure obligations consequent on it and a similarly enduring target market. The detailed target market identification (using ESMA categories) for this is also set out in Schedule 1.

Simple bonds

14. Furthermore, the PG regime acknowledges[6] proportionality means that the PG rules *"could be relatively simple for certain simple, products distributed on an execution-only basis where such products would be compatible with the needs and characteristics of the mass retail market."*

Other enduring retail target market bonds

15. Although outside the context of this paper, it is worth noting that enduring retail target markets may be identitified for other bonds designed for retail investors. The detailed target market identification (using ESMA categories) for this will vary according to the individual circumstances concerned.

Negative target market, legends, co-manufacturer agreement and scenario analysis

16. A negative target market is unlikely for bonds contemplated by this paper given diversification/portfolio considerations and absent the exercise of regulatory intervention powers. However, any such negative target market will be subject to consideration in the specific circumstances.

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[4] The Prospectus Directive (in due course the Prospectus Regulation) and the Transparency Directive.

[5] Prospectus Amending Directive Recital 19 / Prospectus Regulation Recital 57.

[6] MiFID II Delegated Directive, Recital 18.

17. Wording for PG regime legends is set out in Schedule 2.

18. Specific Article 9.8 wording seems likely to be included in subscription agreements.[7] Such wording seems likely to acknowledge the PG regime and to cover the product approval process (and notably the target market approach) and distribution channels. Schedule 5 of the ICMA1 paper sets out some example wording which is equally relevant in respect of this paper.

19. In relation to a manufacturer's obligation to undertake scenario analysis and assess the risks of poor outcomes for end investor clients posed by bond instruments pursuant to MiFID II Delegated Directive Art.9.10, manufacturers may note that bonds are subject to a number of risks. These may include, among others, liquidity risk, interest rate risk, foreign exchange risk, volatility risk, macroeconomic or geopolitical risk, regulatory risk, market risk and risk of loss of capital. Manufacturers may wish to consider setting out in more detail the nature of the above risks, and any other risks that they identify that might impact investor outcomes, when undertaking scenario analysis.

Debt issuance programmes

20. For simplicity, the drafting set out in Schedule 2 relates to 'standalone' bond issuance rather than to debt issuance programmes and related drawdowns. ICMA will separately outline variants for use in a programme context.

Conclusion

21. ICMA will continue to focus on the PRIIPs and PG regimes with its member committees and keep members updated.

[7] See MiFID II Delegated Directive, Art.9.8: *"[MiFID] firms, where they collaborate, including with entities which are not authorised and supervised in accordance with [MiFID II] or third-country firms, […] [are] to outline their mutual responsibilities in a written agreement."*

Schedule 1

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Retail investor target market identification using ESMA categories

Category	***Rationale***
The type of clients to whom the product is targeted:	Retail investors who are looking for contracted repayment of the amount invested and need a predictable return profile. The features of bonds which are not ESMA complex (including those of EEA-related official borrowers) are generally well understood, including by retail investors. 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. Protections are provided by law and regulation. Retail investors also have the ability to access (to the extent they require or wish) IFAs and other independent advisers. As such, the relevant financial instruments are compatible with a target market of retail investors.
Knowledge and experience:	Bonds which are not ESMA complex (including those of EEA-related official borrowers) are easy to understand, and retail investors will have sufficient knowledge and experience to understand them. 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. Given the amount of information available through market-standard and mandatory and otherwise generally available disclosures, a typical retail investor has a sufficient degree of knowledge and experience about the features of such bonds and any thematically related areas that help understand the product, as well as access (to the extent it requires or wishes) to IFAs and other independent advisers.
Financial situation with a focus on the ability to bear losses:	Given the nature of bonds which are not ESMA complex (including those of EEA-related official borrowers) and the amount of information available through press and mandatory disclosures, a typical retail investor has a sufficient degree of understanding that the potential loss profile associated with such bonds is 100% capital loss and can access, to the extent it requires or wishes, IFAs and other independent advisers. 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.
Risk tolerance and compatibility of the	Given the nature of bonds which are not ESMA complex (including those of EEA-related official borrowers) and the amount of

risk/reward profile:	information available through mandatory and market-standard disclosures and otherwise generally available, a typical retail investor has (i) a sufficient degree of understanding that the risk profile of a simple bond requires a willingness to accept some price fluctuations due to interest rate movements, market volatility and borrower insolvency risk in exchange for the opportunity of higher returns than pooled products (given their additional cost layer) and (ii) a sufficient ability to make an appropriate assessment of the risks associated with an investment in the relevant product, and access, to the extent it requires or wishes, to IFAs and other independent advisers. 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.
Clients' objectives and needs:	Given the nature of 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 light of the above, all distribution channels are appropriate for bonds that are not ESMA complex and suitability- or appropriateness-based channels are appropriate for certain ESMA complex bonds.

Schedule 2

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PG legends

Note: Relevant legends relating to the PRIIPs regime need to be considered distinctly. See paragraph 3 of the Explanatory Note to this paper.

Long-form – For prospectuses, final terms and other documents[8]

MiFID II product governance / Retail investors, professional investors and ECPs target market – Solely for the purposes of [the/each] manufacturer's product approval process, the target market assessment in respect of the [Notes] has led to the conclusion that: (i) the target market for the [Notes] is eligible counterparties, professional clients and retail clients each as defined in [Directive 2014/65/EU (as amended, "MiFID II")][MiFID II]; ***EITHER*** [9][and (ii) all channels for distribution of the [Notes] are appropriate[, including investment advice, portfolio management, non-advised sales and pure execution services][10]] ***OR*** [11][(ii) all channels for distribution to eligible counterparties and professional clients are appropriate; and (iii) the following channels for distribution of the [Notes] to retail clients are appropriate - investment advice, portfolio management, non-advised sales and pure execution services - subject to the distributor's suitability and appropriateness obligations under MiFID II, as applicable]. Any person subsequently offering, selling or recommending the [Notes] (a "distributor") should take into consideration the manufacturer['s/s'] target market assessment; however, a distributor subject to MiFID II is responsible for undertaking its own target market assessment in respect of the [Notes] (by either adopting or refining the manufacturer['s/s'] target market assessment) and determining appropriate distribution channels[, subject to the distributor's suitability and appropriateness obligations under MiFID II, as applicable][12].

Short-form – For new issue announcements

MiFID II retail investors, professional investors and ECPs target market – Manufacturer target market (MIFID II product governance) is eligible counterparties and professional clients (all distribution channels) and also retail clients ([all / suitability- or appropriateness-based][13] distribution channels).

[8] This drafting relates to 'standalone' bond issuance. Consideration will need to be given to adapting this language for a debt issuance programme and related drawdowns. See paragraph 20 of the Explanatory Note to this paper.

[9] Include for bonds that are not ESMA complex.

[10] This list may not be necessary, especially for bonds that are not ESMA complex where all channels of distribution may be appropriate. It reflects the list used in the examples in the ESMA Guidelines.

[11] Include for certain ESMA complex bonds.

[12] Include for certain ESMA complex bonds.

[13] Include the latter option for certain ESMA complex bonds.

Very short-form – If needed by any third party market/trading screens

MiFID II retail investors [(subject to suitability/appropriateness)][14], professional investors and ECPs target market

[14] Include for certain ESMA complex bonds.