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CMRP implementation: MiFID II/R product governance

On 26 February, the EU's Capital Market Recovery Package (CMRP) was published in the *Official Journal of the EU* as Directive (EU) 2021/338. Regarding the alleviation of the scope of the MiFID product governance regime, there were no significant differences with the trilogue outcome reported at page 41 of the 2021 First Quarter edition of this Quarterly Report. In terms of national transposition, EU Member States are due to adopt and publish these CMRP provisions by 28 November 2021 and apply them by 28 February 2022.

Then on 21 May, ICMA responded to a consultation by the Swedish Ministry of Finance, regarding Swedish transposition of the CMRP's alleviation of the scope of the MiFID product governance regime. The response noted that the proposed Swedish implementation seemed narrower than the EU-level legislative text in one sense (that bonds with no embedded derivative at all would remain subject to the product governance regime) as well as wider in another sense (that bonds with other embedded derivatives in addition to a makewhole clause would no longer be subject to the product governance regime), with potential implications arising from local variations of implementation. Distinctly by a 7 May Decree, Germany also implemented the alleviation on a narrow basis.

However, ICMA has subsequently learnt that, notwithstanding the drafting of the EU-level text, the actual intention of the EU co-legislators relating to the trilogue outcome was that only bonds with a makewhole clause (but no other embedded derivatives) be exempted from the MiFID product governance regime. In this respect, some of the apparently narrower national implementations may simply be making consequent corrections to the formal EU legal text.

The market practice implications of all this remain to be seen. However, since the conceptually flawed nature of the PG regime is at the moment significantly mitigated through the "ICMA1"and "ICMA2" approaches to compliance (as noted in ICMA's May 2015 response to the European Commission's MiFID review consultation and reported at pages 37-38 of the 2020 Third Quarter edition of this Quarterly Report), it seems unlikely that bond underwriters (as MiFID manufacturers) will be willing to expend resources implementing "lighter" internal compliance policies and procedures for just bonds with a makewhole clause but no other embedded derivatives (rather than a wider universe also including simpler bonds with embedded derivatives at all).

Additionally, in this respect, regarding the CMRP's alternative alleviation to the scope of the MiFID product governance regime (covering financial instruments marketed or distributed exclusively to eligible counterparties), initial industry perception has been this may be of limited use given it would seemingly involve a material investor base limitation and a significant logistical repapering burden.

Consequently, it seems likely that prior market practices will continue unchanged by the CMRP. In any case, ICMA will continue to engage with relevant authorities, including through the Commission's current consultation on an EU strategy for retail investors, to try to ensure that the EU's formal review of MiFID addresses the product governance regime's conceptual flaw by removing commoditised funding products such as Eurobonds from its scope of application.

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The CMRP: MiFID II/R product governance

Further to coverage in the 2020 Fourth Quarter edition of this Quarterly Report (on pages 37-38), the European Council, Parliament and Commission reached a consensus in Capital Markets Recovery Package (CMRP) trilogue on amendments to MiFID, including to the scope of the product governance regime. The Council published a *Confirmation of the Final Compromise Text* on 15 December 2020.

The trilogue process reconciled the Council's 19 October common position and the Parliament's 25 November amendments, as well as the Commission's initial 27 July proposal. The amendments to the scope of MiFID's product governance regime are set out in Article 1(2)(b) (inserting a new make-whole clause definition into MiFID Article 4(1)) and in Article 1(3) (inserting a new Article 16a into MiFID), and also commented in Recital 4. (Article 2a also provides for a review of product governance by 31 July 2021.)

These amendments exclude from the scope of the product governance regime (technically the exclusion is from the requirements of MiFID Articles 16(3)#2-#5 and 24(2)) both:

- bonds (not just "corporate" bonds) with no other embedded derivative than a make-whole clause (as defined); and
- financial instruments marketed or distributed exclusively to eligible counterparties.

The exclusion is narrower than some of ICMA's previous exclusion suggestions:

- instruments that would be non-complex but for the inclusion of terms that do not adversely affect the expected return (see the 2020 Fourth Quarter edition of this Quarterly Report on page 37) or even all bonds (see the 2020 Third Quarter edition of this Quarterly Report on page 37);
- professional investors, including under the existing technical categories such as denominations of €100,000 or more, etc (see the 2020 Third Quarter edition of this Quarterly Report on page 38).

The exclusion is nonetheless significant (as well as being wider than the Commission's original proposal to exclude just corporate bonds having a make-whole clause), though industry will still need to digest the final drafting in terms of working out the full implications. In any case, however, the exclusion's impact as an alleviation will be limited in the absence of the scope of the PRIIPs regime being similarly narrowed.

The Parliament and the Council will now be called upon to adopt the amendments formally without further discussion, possibly in February 2021 (after the usual legal-linguistic revision of the text). EU Member States would be required to implement the relevant amendments into national law (MiFID being a Directive and not a Regulation) within nine months from their entry into force (on the 20th day following *Official Journal* publication).

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The CMRP: MiFID II/R product governance

On 24 July, as part of its Capital Markets Recovery Package (CMRP), the European Commission published a proposal for amendments to MiFID that *inter alia* touches on the scope of MiFID II/R's product governance (PG) regime. The Commission's proposal in this respect is for "corporate bonds with make-whole clauses" to be excluded from the regime, with the Commission separately acknowledging a "need [for this] to be complemented by a clear rule" that a make-whole provision does not of itself make such corporate bond instruments "packaged" under PRIIPs.

There has indeed been substantial debate about whether instruments with certain terms (make-whole provisions notably) are indeed packaged and so require a KID (if being made available to EEA retail investors), or whether they are part of the simpler, non-packaged, universe of instruments not so subject (see *inter alia* #3-7 in ICMA's September 2018 response to an FCA consultation, the ESAs' 19 July 2018 letter under *"callable"* and BaFiN's 22 August 2019 statement at #4). Since all MiFID II/R instruments are anyway within scope of the PG regime, a different debate has previously occurred in that respect. That is whether the PG regime should apply at all to bonds (or at least "non-complex" bonds if more legislatively expedient) and also that applying it to professional investors seems pointless practically (see *inter alia* ICMA's 15 May response to the Commission's MiFID review consultation reported at pages 37-38 of the 2020 Third Quarter edition of this Quarterly Report).

An explanation for the Commission's proposal to exclude corporate bonds with make-whole clauses from the PG regime might then be that it is a stepping-stone to a matching exclusion from the PRIIPs regime. In this respect, however, it would seem illogical not also to exclude even simpler products from the scope of the PG regime (bearing in mind also that such instruments can be sold on an execution-only basis, with PG target market definitions thus being arguably inconsequential). One might thus provide that the PG regime excludes non-complex instruments (an established MiFID concept and thus expedient), together with any instruments that would be non-complex but for the inclusion of a make-whole clause. One could even exclude, on a more conceptual and less instrument-specific basis, any instruments that would be non-complex but for the inclusion of terms that do not affect (adversely) the instrument's expected return (ie 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). It is intrinsic that such instruments raise no additional risks that are difficult to understand.

At the time or writing, EU Member States were reportedly also debating potentially widening the Commission's proposed exclusion. And the European Parliament's *rapporteur* had suggested, in his draft report (at amendments #3-#5 on pages 7-9), that the scope of the PG regime exclude *inter alia* non-complex bonds admitted to regulated markets, equivalent markets and MTFs. This would however leave out bonds with make-whole clauses, since callable bonds are characterised as complex under ESMA's February 2016 *Guidelines on Complex Debt Instruments and Structured Deposits*.

ICMA will continue to follow and, as appropriate, engage in this dossier as it develops.

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MiFID II/R review: investor protection in primary markets

On 15 May, ICMA submitted its response to the European Commission's public consultation on the review of the MiFID II/ MiFIR regulatory framework.

Parts 1-4 of the investor protection aspects (at pages 36-56) and also Q.90 (at page 90) are addressed from the perspective of Eurobond primary markets, mostly in relation to MiFID's product governance and inducements regimes – but also touching on a proposed new semi-professional client category, a proposed EU database for comparing different investment types, certification for staff providing investment advice and allocation justification recording.

Product governance: scope

The response notes MiFID's product governance regime as 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 regime has in practice (in combination particularly with the PRIIPs regime and also partly with the EU prospectus regime's retail disclosure requirements) further diminished borrowers' appetite to offer to retail investors.

The response also notes bonds tend to be "non-complex" from a MiFID perspective, with some being only technically "complex" (eg being unlisted or including a call or put at or above par). This is because they do not include terms that would affect an investors' return expectation – ie the contractual rights to return of principal and (where applicable) to regular and non-deferrable interest payments – and so involve no additional risks that are difficult to understand.

The product governance regime's conceptual flaws arise also in requiring an underwriting syndicate, of several banks relating to a bond issue many years earlier, to periodically redefine the target market for the bonds concerned. This is both from a logistical perspective (underwriters being retained by borrowers for the initial issuance transaction only and then potentially significantly changing their corporate form and business models over time) and from a financial stability perspective (the risk of fire sales flowing from changed target markets).

In this respect, the response queries whether the product governance regime should apply at all to bonds (though acknowledging, if more expedient from a legislative drafting perspective, that the regime might just exclude "non-complex" bonds) and also noted bonds should be confirmed as not being PRIIPs (citing, at #7 of an ICMA September 2018 consultation response, an option to do so without the Commission having to rule on individual product features). However, many corporate borrowers have got used to seeking funding away from EEA retail and so administrative burden alleviation will not necessarily cause mass retail bond markets to return to Europe.

At the very least, from a practical perspective, it would seem pointless for the product governance regime to apply where professional investors are involved (whether acting on their own account, as discretionary managers or as advisers) – and so in any of the existing technical categories of (i) bonds with denominations of €100,000 or more, (ii) "qualified investor only" offers or (iii) bonds admitted to "qualified investor only" markets or market segments.

The response also references the "ICMA1" (all bonds/qualified investors only) and "ICMA2" (simple listed bonds/retail investor inclusive) approaches to target market definition, which may have helped mitigate some of the above in practice, at least for the institutional bonds markets that real economy borrowers rely on most.

Product governance: "negative" target market

Regarding the target market ("TM") concept, the response distinguishes:

(a) a "positive" TM of intentionally "targeted" investors for whom a product is theoretically compatible (compatibility being intrinsic to the characteristics of both product and investor and distinct from any other limitations, such as selling restrictions based on administrative formalities);

(b) a "neutral" TM of investors for whom a product might well be theoretically compatible, but who are not targeted; and residually

(c) a "negative" TM (if any) of investors for whom a product is theoretically incompatible.

In the Eurobond context, any underwriters who are technically "manufacturers" and the borrower (as the client and also potentially a "manufacturer" depending on its own MiFID authorisation status) will have expended significant effort to agree a manufacturer positive TM that is perceived to be robust and enduring over time. Consequently, they do not want to have to deal with any wider individual "distributor" TMs that do not concern them (the definition of "distributor" technically capturing a secondary markets trader many years later who has no connection with the borrower or the original underwriters). That said, it appears that typically MiFID entity secondary market sellers anyway do not define their TMs wider than manufacturer positive TMs (partly due to the operational burdens involved).

It is conceivable there could be rare circumstances in which it is in an investor's best interests to receive a product (excluding mere investor insistence), notwithstanding that it falls within a manufacturer's negative TM – eg for hedging purposes. In this respect, the product governance regime's current permission of sales in a negative TM is associated with regulatory guidance making clear that this should be a rare occurrence in need of significant justification. It thus seems that the regime already provides an appropriate degree of protection and that further restrictions on sale within any negative TM would be unnecessary.

Incidentally, in the context of syndicated Eurobond issuance, the ICMA1 and ICMA2 approaches note that a negative TM is unlikely for most bonds given diversification/portfolio considerations and absent the exercise of regulatory intervention powers, but that any such negative TM would be subject to consideration in the specific circumstances.

Product governance: adaptation to digital and online offers

In terms of any need to adapt the product governance regime to digital and online offers, the response notes that, as far as wholesale context is concerned, markets have for a long time been working remotely at speed (on the telephone). This underlying dynamic remains generally unchanged in the digitised/online context. So, to the extent MiFID's principles were already suited to remote working at speed, then this would seemingly continue to be the case.

New category of semi-professionals clients

Regarding the proposed new category of semi-professionals clients, the response notes that (retail) *client* scope is effectively superseded by the above overarching concerns around *product* scope. However, if the Commission nonetheless ultimately decides to widen access for retail clients that have some distinct knowledge and means, then it may be simpler (to avoid a significant, and potentially dis-incentivising, repapering consequence) to adjust the existing threshold tests for retail investors to be able to opt for professional status on request. (In this respect an investible portfolio measure seems more robust than an income-based test and knowledge/experience could be based on recognised third party certification as a further alternative option to an assessment of trading history.)

EU database for comparing different investment types

The response expresses caution about the purpose of a suggested EU database for comparing different investment types. If it is merely to serve as a quick "initial sorter" of products into specified classes ahead of further review (similarly to credit ratings helping "high yield" investors to avoid reviewing "investment grade" securities), that is one thing. However, such a standardised comparator is unlikely to be able to serve as "the" basis for "informed" investment decisions – as public commentary on the implementation of the PRIIPs regime has illustrated.

Inducements and costs & charges

In terms of MiFID's inducements and costs & charges regimes, the response notes ICMA having sought to assist firms with the concepts involved, but that practical application in the context of the remuneration of underwriters (generally involving combined fees for combined services to borrower clients, including placing/selling) has varied – depending on guidance from some national regulatory sources, the type of fees involved and how individual underwriters and/or how individual transactions are organised. However, such remuneration has at least remained possible.

The response emphasises that:

- characterising such remuneration as an inducement (per ESMA technical advice ESMA35-43-2126, #20-24); and
- separately proposing that inducements be banned (whether directly/explicitly as the consultation envisages or indirectly/implicitly because of any restrictive national interpretations/implementations of ancillary criteria), would prohibit real economy borrowers from being able to remunerate, and so presumably retain, anyone to manage their bond offerings.

Aside being unclear how this promotes investor access to independent advice (as the consultation suggests), losing such external support could jeopardise the success of borrowers' bond fundraising exercises – individually and then consequently on an aggregated, systemic, level for the European economy. This is because borrowers typically do not have the necessary expertise and resources internally to effectively manage such offerings alone.

As well as being damaging to Europe's real economy, characterising underwriter remuneration as banned inducements would be unnecessary from an investor protection perspective (at least to the extent the MiFID entity retained and remunerated by a borrower is not also providing, on an unsegregated basis, "investment advice" or "portfolio management" services to investor "clients" regarding the bonds concerned). This is, in the context of syndicated public offerings, because:

(1) it is unclear what investor-facing "client" service might be involved – (a) not "execution of orders" as underwriters are not "acting to conclude" (ie satisfy) investor bids on investors' "behalf", but rather allocating on their borrower client's exclusive behalf (as recognised under specific underwriting and placing provisions of Arts. 38-43 of the MiFID Delegated Regulation EU/2017/565); and (b) not "reception and transmission of orders" as

there is no transmission to another entity/platform for such execution; Also, to the extent any "investment advice" or "portfolio management" is being provided on a segregated basis within the same MiFID entity, it would seem unfair that those investor clients be effectively prevented from participating in the corporate bond issues concerned;

(2) ESMA seems to acknowledge there may be no investor-facing "client" service or at least a need for further analysis – ESMA's technical advice is (a) partly conditional (noting disclosure of placing fees "where […] also […] service to the investor") though strangely also partly unconditional ("underwriting fees should be disclosed where […] also sells […] to investors" but without citing any supporting MiFID provisions) and (b) open to "further analysis" for share IPOs, indicating the advice is not definitive (presumably also the case then for new bond offerings, as it is unclear why IPOs would merit preferential treatment);

(3) underwriter remuneration is unrelated to investor outcomes – underwriters act on their borrower client's behalf to the best of their ability to execute a new issue further to conduct requirements, irrespective of remuneration from the borrower ("incentive"/"success" fees mechanically linked to outcomes are not in use anyway) and, in any case, syndicated issuances are iteratively tailored/priced to market reception (with indicative terms revised in line with investor bids – literal price "discovery"); and

(4) investors do not care – Eurobond investors have never really shown interest in underwriter remuneration (with non-inducement context reports of investor reminders on how to request fee information resulting in no substantive uptake), which is unsurprising given (3) above/pricing (spread to benchmark) and other material information being public on screens and pursuant to prospectus rules.

However, borrowers do care about their right to commercial privacy. There have been reports of borrower concerns regarding their rights to commercial privacy being sacrificed unjustifiably (in the absence of any actual countervailing investor protection concern): why should they advertise to the world, and so to all potential providers of underwriting services, how high they might be willing to pay to hire such service providers? It seems entirely rational for borrowers to wish to preserve their ability to negotiate the lowest possible remuneration commensurate with their specific servicing requirements.

The response also notes incidentally that there are distinct net proceeds disclosure requirements under the EU's Prospectus Regulation for both retail offerings (Delegated Regulation EU/2019/980, Anx.14, #3.2) and now, albeit strangely, institutional market listings (idem, Anx.15, #3.2).

Certification for staff providing investment advice

The response notes incidentally, regarding certification for staff providing investment advice, that any education requirements should be appropriately calibrated to the areas of advice/information being given (eg advisers in the fixed income space should not need granular certification relating to commodity investments).

Allocation justification recording

Lastly the response also notes broad consensus having been reached regarding how to apply MiFID's allocation justification recording regime (the experience so far having mainly been of added administration without meaningful benefits for borrowers or investors).

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Primary Markets

by Ruari Ewing

MiFID II/R product governance and PRIIPs

The second quarter edition of this Quarterly Report referenced ICMA's 15 March response to the German Ministry of Finance's consultation on MiFID II/R (with the primary market coverage essentially referencing ICMA's report on *MiFID II and the Bond Markets: The First Year* published on 6 December 2018).

On 27 August, the German Ministry of Finance published a consequent position paper, *Necessary Amendments and Revisions to Investor Protection Provisions in MiFID and PRIIPs*, which notes generally that its "findings did not reveal the need for a comprehensive review", though proposes some near-term action and some subsequent work.

More specifically regarding MiFID II/R product governance, the paper:

- as a near-term focus, suggests that a periodic review for simple financial instruments should not be required since such "instruments (eg plain vanilla bonds, shares) used for corporate financing do not change their structure or payment profile during their life cycle" and such a review "does not lead to additional benefits for clients"; and
- in the medium term, notes questions as to whether the product governance regime is "needed at all" and so proposes some analysis as to the regime being "simplified or revoked" (notably in light MiFID's suitability requirements).

Regarding the PRIIPs regime's scope (including make wholes) and in the near term, the paper notes reduced retail availability due to the European Commission's "current interpretation regarding the scope of PRIIPs" (see the Commission's 14 May reply to the ESAs' 19 July 2018 letter requesting clarification of the PRIIPs regime's scope) and proposes bonds "should not become packaged products simply by adding a make-whole clause" and that it should be made clear that the PRIIPs regime does not apply to "plain vanilla corporate bonds, including bonds with a make-whole clause (eg bonds with the amount repayable directly linked to an interest rate index)."

For now, in a parallel development, BaFin stated (in a 19 September non-binding English translation of a 22 August Guidance Notice) that its administrative practice is to treat corporate bonds as packaged under the PRIIPs regime *inter alia* where they include a "redemption at make-whole" feature (as the amount repayable is subject to fluctuations because of exposure to reference values, albeit only in certain circumstances, namely in the case of early redemption). The translation also states that, exceptionally, BaFin would not treat linking the amount repayable to an interest rate index (such as EURIBOR or LIBOR) as packaging under PRIIPs (by analogy with deposits that are explicitly excluded).

Regarding costs and charges and performance scenarios, the German Ministry of Finance paper notes that the MiFID and PRIIPs provisions on client information (notably on costs) should be harmonised "to avoid a misleading duplication" and that the performance scenarios provisions "lead to misleading presentations" for some products (with manufacturers "forced to add written comments that the presentation should be disregarded").

Distinctly, ICMA responded on 26 September to a Czech Ministry of Finance 23 August consultation relating to the National Strategy for the Development of Capital Market in the Czech Republic 2019-2023. The response warns, in light of the current debate about PRIIPs' dampening impact on retail access to bond markets, that introducing a key information document for all bond offerings (not just packaged retail products) seems likely to be severely detrimental to the existing debt capital markets in the Czech Republic, let alone their future development.

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MiFID II/R: the first year in the primary markets

On 6 December 2018, ICMA published *MiFID II/R and the Bond Markets: the First Year - An Analysis of the Impacts and Challenges of MiFID II/R Implementation Since January 2018*.

It includes some specific coverage of the primary markets, which have been affected by MiFID as many underwriters participating in new issue syndicates are MiFID-authorised entities. These new measures include allocation justification recording (in relation to underwriting & placing), the inducements and costs & charges regimes, and product governance. The primary markets community has also experienced the Packaged Retail and Insurance-Based Investment Products (PRIIPs) regime, to the extent that certain bonds are potentially "packaged" and are being made available to retail investors in the EEA.

The provisions on allocation justification recording relate to MiFID firms providing a MiFID placing service to issuers being required to keep an "audit trail", non-public written record of the justification for each investor allocation made. The rationale for this is to identify potential conflicts of interest, as underwriters look to balance the interests of their issuer clients with the interests of their buy-side relationships. In practice, the underwriting community reached broad consensus on allocation recording principles, with the underwriter responsible for billing and delivery generally circulating an initial draft record that other syndicate members can then adopt (modifying it as relevant for their internal needs). The experience so far has mainly just resulted in added administration for underwriters, and it remains to be seen whether this measure will have meaningful benefits for issuers or investors.

The provisions on inducements and costs & charges require that firms providing MiFID services (eg order reception/transmission to any investor "client") disclose to their client in advance any fee/commission or non-monetary benefit received from a "third party" in relation to the client service. Firms must also *inter alia* disclose *ex ante* and annually *ex post* the costs and charges relating to the services and financial instruments concerned, (also "encompassing any third-party payments"). In practice, agreement on whether these rules apply to the disclosure of underwriting fees has varied, depending on guidance from some national regulatory sources, the type of fees involved and how individual underwriters and/or how individual transactions are organised. Moreover, the prevailing view is that investors have little or no interest in the level of bond underwriting fees as these are very rarely a material factor in making an investment decision regarding bonds.

The PRIIPs regime requires any person "manufacturing" a "packaged" product, before it is "made available" to retail investors in the EEA, to publish a key information document (KID) of no more than three pages and then regularly review it, and if needed, publish a revised KID. Any person advising on, or selling, such a product must provide retail investors in the EEA with the KID in good time before those retail investors are bound by any contract or offer.

The product governance (PG) regime characterises MiFID II persons that "create, develop, issue and/or design financial instruments, including when advising corporate issuers on the launch of new financial instruments" as "manufacturers". It requires that collaboration between manufacturers must be documented in an agreement. MiFID II persons that "offer or sell", or "offer or recommend", financial instruments are "distributors" for PG purposes (with no connection to the manufacturer being explicitly required). Manufacturers must identify, and communicate to distributors, a compatible target market of investors and periodically review that target market. Distributors must identify their own target markets (by either adopting the manufacturer's target market or refining it). These requirements are all applicable on a "proportionate" basis.

The PRIIPs regime is designed to enhance protection of retail investors participating in the structured products markets, while the PG regime imposes a type of suitability obligation on different market participants with respect to all products and investors. In this regard, the two regimes have significant problematic features that have led to unintended consequences, as well as raising concerns over the fundamental practicability of compliance.

Under PRIIPs, certain authorities have taken the position that the inclusion of a term or condition that deviates only slightly from what is regarded as a plain vanilla bond will bring that security into scope as a packaged product, requiring a KID to be produced. An example would be the inclusion of a "make whole" provision. The fact that this and other terms can be to the benefit of investors but bring a bond within PRIIPs, combined with the fact that equities are not subject to the PRIIPs regime yet present greater risks to the retail investor, has led many to question the efficacy and rationality of the PRIIPs regime. Under PRIIPs, a KID must not only be accurate but may also be interpreted to require the inclusion of all material information. The imposition of this requirement with attendant issuer liability for both a three-page KID and a full 100+ page prospectus has not only created perplexity but more significantly led many issuers to refuse to produce a KID and instead restrict placement of newly issued bonds to non-retail investors in the EEA.

The PG regime has had similar consequences. It has effectively created an investor suitability obligation, not just at the point of sale (the approach taken in the past by regulation), but also imposing this obligation on issuers, underwriters, and secondary market sellers over the entire lifetime of the instrument. The practical burden of compliance with PG has caused many EU-originated issues to curtail altogether placement of bonds to retail investors (see the 2018H1 vs 2017H1 percentage change in EUR benchmark issuance reported in the Fourth Quarter 2018 edition of this Quarterly Report).

While the goal of these primary market aspects of MiFID and PRIIPs is enhanced investor/consumer protection, it seems the impact has mainly been an increase in administrative burdens and a reduction in retail access to the bond markets. ICMA will continue to engage EU authorities and national competent authorities to better achieve desired regulatory outcomes while maintaining resilient and efficient markets.

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FCA: *Call for Input on PRIIPs*

On 28 September, ICMA responded to a UK FCA *Call for Input* on PRIIPs.

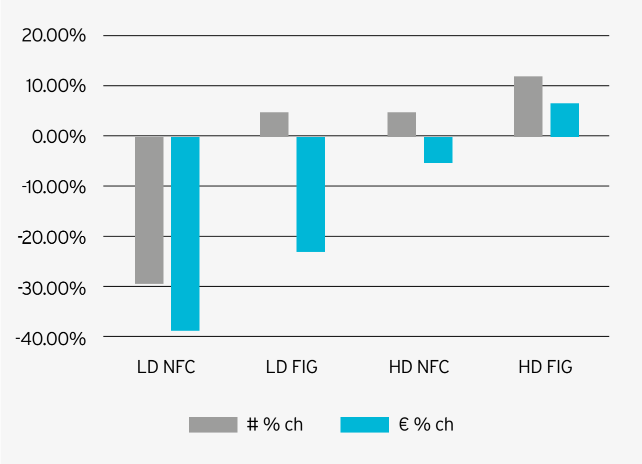
The ICMA response notes that the product scope of the PRIIPs regime has been confusing in practice. It seems to have been interpreted by some as wider than initially expected, eg to include some vanilla bonds. This needs to be rectified given the potential sanctions for PRIIPs availability to EEA retail investors without a KID and the apparent consequential avoidance of retail investors by many borrowers (see further below). In this respect, the ESAs' suggestion of granular scope clarifications in their 19 July letter 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, the response suggests some possible wording.

The response notes that challenges within the KID include the fact that vanilla bonds involve no costs and charges. Also, the synthetic risk indicator involves seemingly arbitrarily weighted components. And lastly, the prescribed performance scenario methodology seems flawed, potentially misleading and needs to be amended.

The response flags that 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 (ie confidence that the borrowed amount can be used for the whole bond term) – certainly for investment grade benchmark-funding borrowers in the international markets. Such borrowers consequently prefer to avoid retail investors unless they are clearly outside the product scope of PRIIPs.

In this respect, ICMA's full first half 2018 findings seem to indicate a 30%-40% decline in low denomination non-financial corporate (LD NFC) issuance, in contrast to high denomination (HD) and financial institution (FIG) issuance – see chart. (Same basis first quarter data had indicated a 60% decline as reported in the Second Quarter 2018 edition of this Quarterly Report.) 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. (See further separate article in this edition: *Bond denominations 2000-2018*.)

2018H1 vs 2017H1 percentage change in EUR benchmark issuance (by number and value of transactions)



Source: ICMA/Dealogic

The response recalls 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, the response flags a couple of apparent inaccuracies in the text of the Call for Input.

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Primary Markets

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PRIIPs and MiFID II product governance: the initial experience

Since the beginning of the year, various ICMA members have reportedly been using the ICMA1 ("all bonds"/"professionals only") and ICMA2 ("simple listed bonds"/"general retail") approaches to the PRIIPs and MiFID II product governance (PG) regimes. These were outlined in, respectively, the 2017 Q4 and 2018 Q1 editions of this Quarterly Report.

Various ICMA working group deliberations continue, however, as: (i) the most directly affected market players (the more active "manufacturers" and "distributors") continue to deepen and widen their initial understanding of the regimes (including more marginal scenarios) and explore potential new compliance approaches; and (ii) other stakeholders (less active manufacturers/distributors, more geographically remote intermediaries, other borrowers, related advisors, investors and also regulators) familiarise themselves and react to "manufacturer"/"distributor" approaches. In this respect, ICMA staff presentations recapping on current dynamics have been published on ICMA's *MiFID II/R in primary markets* webpage.

There was significant press coverage in the major UK financial press at the start of the year concerning PRIIPs key information documents (KIDs) allegedly produced according the officially prescribed methodologies yet presenting results so extreme as to be misleading. The UK FCA subsequently acknowledged that, for some PRIIPs, "the 'performance scenario' information required in the KID may appear too optimistic and so has the potential to mislead consumers" and that reasons for this may include "the way the calculations in the RTSs must be carried out". The FCA noted in this respect being comfortable with manufacturers that produce KIDs "provide explanatory materials" to provide context and set out their concerns. But query then additional space sufficiency within the KID's strictly limited three pages and any "disclosure chain" considerations (the KID has to be a standalone document albeit with a strictly defined allowance for cross-references). ESMA's Chair, Steven Maijoor, has recently stated that ESMA is working on further guidance, on performance scenarios-related issues in particular. However, none of this seems likely to encourage, at least for now, benchmark borrowers who can access the institutional markets to produce KIDs (having set their likely focus on certainty of funding against liability considerations in the context of these large funding exposures running into the billions).

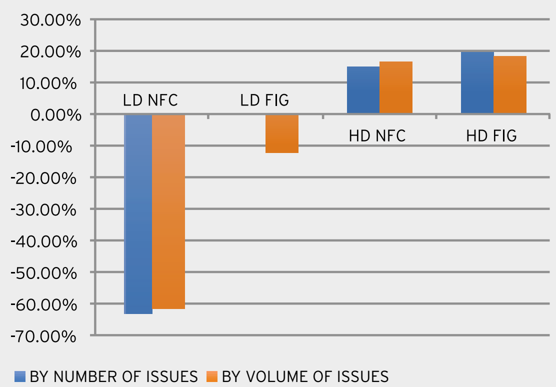
And it is distinctly worth remembering that prior PRIIPs coverage in this Quarterly Report noted potential liability concerns stemming from the PRIIPs KID concept itself (irrespective of the officially prescribed methodologies), starting with the KID's vague purpose – which a speech by ESMA's Chair, Steven Maijoor, interpreted as being *inter alia* to "contain sufficient information to allow consumers to make an informed investment decision". This seems close to the Prospectus Directive test for a full prospectus ("all information [...] necessary to enable investors to make an informed assessment"). It seems challenging, in a €500 million - €2 billion context, to reconcile discharging such a fulsome disclosure test in the KID's three pages, particularly set against the PRIIPs Regulation's absolute prohibition on the KID being "misleading." There is also the specific obligation that the KID include "key" information specified as such under the Regulation: the Regulation's civil liability exemption (for KIDs that are accurate, non-misleading and otherwise consistent with other specified documents such as a prospectus) would not apply to any consequential civil liability claim arising under non-EEA laws such as in the US (an important consideration given the international nature of the bond markets).

ICMA has conducted an initial analysis of Dealogic's new issue data for indications of any new regime impact on the availability of vanilla bonds to general retail investors. It did so by comparing the prevalence of low (€1,000 or less) and high (€100,000 or more) denominations in euro new issue data for 2018 Q1 (as of 21 March) against the equivalent 2017

Q1 data (the single currency scope limitation being to simplify the analysis). Given the many possible types of debt securities (involving different combinations of features) that have evolved to meet borrower and investor needs, there is no exhaustive and authoritative bond type nomenclature. ICMA's analysis consequentially focused on benchmark issuance (aggregate issue sizes of €500 million or more) as a rough proxy for vanilla bonds, since the only other bonds of that size are likely to be asset/mortgage-backed bonds that can be controlled for in Dealogic's nomenclature. Lastly, bonds have not traditionally had generic formal "retail" designations (having rather various retail-like characteristics stemming from regulatory, commercial or other drivers). ICMA's analysis consequentially focused on denomination as a rough proxy for potential retail status. Many bonds have €100,000 denominations, meaning that they can only be bought or sold in sizes of at least that order of magnitude (the trading value of vanilla bonds tends to oscillate around 100% of the denomination's face value – absent default or similar concerns). However general retail investors will only plausibly buy bonds with denominations of around €100, €1,000 or perhaps €10,000.

The analysis[1] by number and value of issuances, as shown in the chart below, reveals a marked decrease in low denomination issuances (over 60% in the case of non-financial corporate bonds), in contrast to 15%-20% increases in high denomination issuances.[2]

Percentage change in issuance 2018 Q1 over 2017 Q1



LD NFC = low-denomination, non-financial corporates; **LD FIG** = low denomination, financial institutions; **HD NFC** = high denomination, non-financial corporates; **HD FIG** = high denomination, financial institutions

Source: Dealogic

It remains to be confirmed whether this very significant reduction in vanilla low denomination bonds (i) indicates an ongoing trend, (ii) is caused by the PRIIPs and/or PG regimes and/or (iii) will be a concern for European authorities (eg in the context of the EU's CMU objectives). These initial results give food for thought in any case. A simpler statistic yet may be found in the number of KIDs known by ICMA to have been prepared among all benchmark bonds (not just the above EUR data set) since the PRIIPs regime took effect: none so far.

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1. This analysis involved a data set of 953 bond issues worth €882.7 billion, roughly equally split between the first quarters of 2018 (as of 21 March) and 2017. Around a quarter of the issues did not have denomination data and were discarded, leaving 698 issues worth €694.9 billion to analyse (again roughly equally split between the two first quarters). Aside from two issues only with €50,000 denominations, all issue denominations were relatively polarised between low denominations (€1,000 or less) and high denominations (€100,000 or more). 38 asset/mortgage-backed bonds were excluded (as non-vanilla), as were 160 sovereign, supranational and agency (SSA) bonds (as significantly less impacted or even exempt from the new regimes) – thus leaving 498 bonds worth €393 billion from financial institution and non-financial corporate borrowers most likely to be impacted (in a ratio of around 6/4).

2. The excluded SSA issuances decreased generally, though more markedly in high denominations.

MiFID II/R and PRIIPs: implementation in primary markets

by Ruari Ewing

Professional investors (PRIIPs/product governance): Regarding the professional investors' intended target market (all bonds) outlined in some detail in the Fourth Quarter 2017 edition of this Quarterly Report, ICMA has circulated that rationale and related draft forms of language for consideration by transaction syndicates. This includes some of the more salient options available for consideration in terms of measures that might be put in place on issue that could, in varying combinations according to the circumstances, be reasonably expected to result in a target market encompassing sales being made to professional investors only. (Furthermore in this respect, manufacturers should not then be characterised as "making available" to retail investors in the EEA any "packaged" securities for PRIIPs purposes.) It also includes some examples of a written agreement between co-manufacturers that seems likely to be included in subscription agreements. Such an agreement seems likely to acknowledge the product governance regime and to cover the product approval process (and notably the professional investors target market approach) and distribution channels.

Retail investors (PRIIPs/product governance): Regarding a retail investors' intended target market, ICMA has continued to consider various potential approaches (as briefly noted in the Fourth Quarter 2017 edition of this Quarterly Report). Though the product governance regime envisages simple products being compatible with mass retail investors, one initial approach focuses on what one might simplistically summarise as bonds that are simple and listed. More specifically it relates to low-denomination 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 (or analogously subject to similar transparency). In relation to this approach, ICMA has circulated a draft rationale (outlined below) and related draft forms of language for consideration by transaction syndicates. The approach does not address the PRIIPs regime, which needs to be separately satisfied in terms of any KID requirement.

MiFID II/R regulates EEA regulated markets. There are no restrictions on the type of issuer or credit that can be admitted, and suspension is only triggered by non-compliance with periodic and *ad hoc* transparency obligations. Further, bonds other than ESMA complex bonds can be bought by retail investors on an execution-only basis outside the appropriateness regime. So, the regulatory infrastructure contemplates that retail investors can freely buy non-complex bonds provided the transparency obligations are met. It is thus proportionate that a product manufacturer's target market assessment should not be affected by fluctuations in an issuer's credit, provided that the bonds concerned continue to be admitted to the regulated market. In this respect, manufacturer target market reviews of the bond markets would logically conclude that no target market changes are warranted (and any distributor feedback would be expected to be without impact).

Whilst ESMA complex bonds cannot be bought by retail investors on an execution-only basis outside the appropriateness regime, certain ESMA complex bonds do not include terms that would affect the return expected from the product (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. It is thus proportionate that such bond manufacturer's product governance responsibilities should also be based on admission to a regulated market, the disclosure obligations consequent on it and a similarly enduring target market – albeit not outside the appropriateness regime.

The EU has as a matter of public policy exempted from its initial and periodic transparency regimes bonds issued by an EEA Member State or by related official bodies. It has been noted that Member States publish abundant information on their financial situation which is, in general, available in the public domain. Given the connection with Member States of their related official bodies, it follows that such information in their respect should not need to be provided in the prospectus either. It is therefore proportionate that such bond manufacturer's product governance responsibilities (being otherwise the bonds discussed in the preceding two paragraphs) should again also be based on admission to a regulated market, the disclosure obligations consequent on it and a similarly enduring target market.

A negative target market is unlikely for these bonds 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.

Other aspects: ICMA members have further discussed various alternative ways of complying with MiFID II's allocation justification recording, inducements (and costs and charges) and trade and transaction reporting regimes. There seems to be sufficient understanding of the dynamics of the various alternatives for decisions to be made ahead of 2018's bond syndications.

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M PRIIPs and MiFID II/R product governance

ICMA continues to work on anticipated approaches, in the Eurobond markets (ie syndicated cross-border bond issuance), to the product governance (PG) and PRIIPs regimes coming into effect from 2018. These approaches would 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

It may be helpful to recap briefly on the PG/PRIIPs regimes by way of background. For PRIIPs, simplifying substantially: (i) any person manufacturing a "packaged" product, before it is "made available" to retail investors in the EEA, must publish a key information document (KID) and then regularly review it, and if needed, publish a revised KID; and (ii) any person advising on, or selling, such a product must provide retail investors in the EEA with the KID in good time before those retail investors are bound by any contract or offer. For PG, simplifying substantially: (i) MiFID II persons that "create, develop, issue and/or design financial instruments, including when advising corporate issuers on the launch of new financial instruments" are "manufacturers" for PG purposes (with co-manufacturing documented in an agreement); (ii) MiFID II persons that "offer or sell financial instrument[s]" are "distributors" for PG purposes (with no connection to the manufacturer being explicitly required); (iii) manufacturers must identify, and communicate to distributors, a compatible target market of investors and periodically review that target market; and (iv) distributors must identify their own target markets (by either adopting manufacturer's target market or refining it) – all on a "proportionate" basis.

Neither regime "grandfathers" pre-existing bonds and there has been limited consensus on what does *not* constitute a "packaged" product. This is partly due to various public statements by the European Commission and ESMA that seemingly purport to widen the range of what might otherwise have been perceived as "packaged". Practically in the context of syndicated bond issuance, borrowers are understood to be manufacturers for both PRIIPs and (if a MiFID II person) PG purposes (together with, as co-manufacturers for PG purposes only, any MiFID II person underwriters that satisfy the related "advising" characteristic). Though post-2018 "distribution" of pre-2018 bonds is subject to the PRIIPs (if "packaged") and PG regimes, the "manufacturing" of such bonds, however, occurred prior to the PRIIPs and PG regimes coming into effect.

Challenges

Significant practical/logistical challenges are perceived regarding: (i) borrower liability risk in producing a KID in the context of high value / flow transaction bonds (let alone keeping it up to date); and (ii) underwriters' scope to execute extensive target market review procedures, particularly on a co-manufacturer basis that is effectively syndicate/ISIN-specific and given traditional market practice whereby borrowers engage (and remunerate) underwriters for the initial issuance procedure only.

Some of these concerns may abate with practical experience of the new regimes and any future helpful official guidance, but the approaches ICMA is working on seek to account for them in the interim – by focusing on manufacturers: (i) being clear that they are not facilitating availability to retail investors in the EEA of any products that are not outside the scope of PRIIPs' "packaged" concept; and (ii) defining "robust" target markets for PG purposes – ie that are highly likely to endure for the life of a bond and so substantially moderate the ongoing (review process) resourcing burden, this seemingly being simplest in first instance to outline in a proportionate wholesale context of professional investors.

PG professional investors intended target market

On the basis that professional investors (as defined in MiFID II, including elective professionals and discretionary managers) possess the experience, knowledge and expertise to define their needs and objectives, make their own investment decisions and properly assess and manage the risks and returns that they incur, they should be able to buy and hold any bond investment, regardless of specific product type, and therefore the manufacturer of a bond should have then substantively complied with the PG 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 investors (and see further below).

Because professional investors are appropriate target investors for all bond types, this will continue regardless of any changes individual bonds over time. In this respect, manufacturer target market reviews of the bond markets would most likely (if not inevitably) conclude that no target market changes are warranted – at least whilst the MiFID definition of professional investors endures. In this respect, feedback from third party "distributors" (in the specific PG sense) would be expected to be without impact on the target market assessment.

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

A written agreement between co-manufacturers seems likely (beyond generally acknowledging the PG regime and the professional investors target market approach) to address any desired ongoing logistical role attributions. Some co-manufacturer groups may consider in this respect that no specific role attributions are necessary: ie that all tasks be effectively equally shared. Other co-manufacturer groups may wish perhaps to attribute the task of initially receiving any distributor feedback (no matter how unlikely to materialise) and consequentially notifying the other co-manufacturers, as well as defining a technical means of conferring/deciding on any co-manufacturer proposal to amend the target market (again no matter how unlikely to materialise).

Options for measures reasonably expected to result in sales only to professional investors

Various options are available for consideration in terms of measures that might be put in place on issue that could, in varying combinations according to the circumstances, be reasonably expected to result in sales only being made to professional investors. Furthermore in this respect, manufacturers should not then be characterised as "making available" to retail investors in the EEA any "packaged" securities for PRIIPs purposes. The more salient options could include line items in any origination staff formalities e-mail in response to mandate, in any term sheet and/or in any sales staff memorandum, legends in any prospectus and any final terms or pricing supplement and on new issue screens, selling restrictions in any prospectus and any final terms or pricing supplement, counterparty procedures (including in terms of any secondary trading involvement), the absence of a retail prospectus or of a KID, admission to a "qualified investor" segment on an EEA regulated market, MiFID trader PG obligations, markers on market/trading screens and high denominations. ICMA is working on model forms of wording relating to some of the above. However, these are not anticipated to involve debt issuance programmes to be updated on an emergency basis prior to 2018.

Retail investors intended target market

ICMA is also continuing to consider potential target market approaches for retail investors (and to engage with EU and national authorities in this respect). However, public offers conducted on behalf of EEA governments at least have presumably a mass retail target market (on an initial and ongoing basis) as a matter of public policy (EEA government bonds are also exempted from the PRIIPs regime).

Conclusion

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

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Primary Markets

by Ruari Ewing, Catherine Wade and Kate Craven

MiFID II/R product governance and PRIIPs

Introduction

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")[46] 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[47]). 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

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."

The simplest harmonised practice that seems deliverable by 2018 is an "all bonds/all professionals" proportionate TM practice.

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 legislation:* the Prospectus Directive expressly contemplates a wholesale alleviated disclosure regime for RM admissions.

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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MiFID II explicitly states its product governance regime is to be applied "proportionately".

MiFID II: product governance

Among other topics under MiFID II (in effect from 3 January 2018), ICMA has been grappling for over a year with how product governance – traditionally a retail structured market concept – can operate in the institutional funding markets. How does one ensure that a fixed rate bond (a concept in existence for hundreds of years) by a car manufacturer (to, say, fund a new factory creating thousands of jobs to make green vehicles) is "designed" by underwriters for specified "target market" investors' "needs, characteristics and objectives"? (In this respect, professional investors need and want to access the market freely to pursue their often complex, evolving and confidential investment strategies).

At least MiFID II explicitly states its product governance regime is to be applied "proportionately". This will be particularly important in relation to the wholesale debt markets, which provide significant funding to the real economies of Member States, and the approach is consistent with the objectives of Capital Markets Union, which is in part to facilitate such funding, rather than to add unnecessary regulatory burdens to it.

The answer to the above question would then be arrangements to limit distribution to professional investors, who are appropriate target investors for all types of debt securities. This would involve primary market selling restrictions, warning legends and other procedures to restrict distribution to retail investors in the secondary market. Such arrangements would also represent a consistent approach across the MiFID II, PRIIPs and prospectus regimes.

Given the nature and effect of these procedures, they should, without more, satisfy both the initial and the on-going requirements of the product governance regime and enable the wholesale debt markets to continue to operate, for the benefit of issuers and professional investors alike, without excessive additional burden or cost.

In October 2016, ESMA published a consultation on product governance, to which ICMA responded on 4 January 2017 along the lines above. ICMA also responded on 4 January on the product governance aspects of a UK FCA consultation published in September 2016 on MiFID II implementation, mainly on stress testing (flagging that it exceeds MiFID II's scenario analysis requirement and querying its compatibility with vanilla debt securities).

ICMA will continue working to help its members grapple with product governance ahead of the MiFID II implementation date of 3 January 2018.

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