ICMA
International Capital Market Association

Primary Markets

by Ruari Ewing

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).

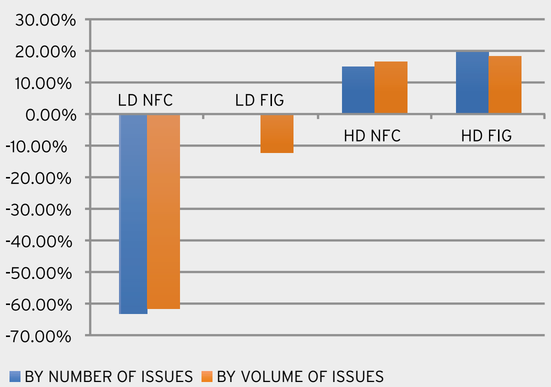
And it is distinctly worth remembering that prior PRIIPs coverage in this Quarterly Report noted potential liability concerns stemming from the PRIIPs KID concept itself (irrespective of the officially prescribed methodologies), starting with the KID's vague purpose – which a speech by ESMA's Chair, 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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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



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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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