ICMA
International Capital Market Association

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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