30 September 2021

ICMA response to UK FCA Consultation Paper CP21/23

PRIIPs - Proposed scope rules and amendments to Regulatory Technical Standards

Key points

- Formal, binding comfort on the scope of PRIIPs via the creation of a new Product Disclosure sourcebook, DISC, is welcome.

- In terms of 'product' scope rules, the FCA's recognition in paragraph 2.16(a) of the consultation that *"To be a PRIP, a debt security must come between the retail investor and an ultimate investment asset which is not purchased by the investor"* is welcome and fundamental. The FCA's proposed list of neutral features in draft DISC 2.2.4 is however inconsistent and should be amended to include five notable product features that do not involve a debt security 'coming between' a retail investor and an ultimate investment asset (voluntary call options, non-NPV par calls, floating rate coupon steps, event-driven coupon steps including sustainability-linked bonds, and caps and non-zero floors).

- In terms of *"made available"* guidance, this should align more closely to minimum denomination and qualified investor exemptions under the UK prospectus regime (which is the subject of a distinct consultation) and should be alternative (rather than cumulative) in the same way that they are under the UK prospectus regime. It should also be clear that third parties illegally selling PRIIPs to retail without a KID does not constitute 'making available' by manufacturers.

Introduction

1. **Focus on PRIIPS scope** – ICMA is responding to certain questions in Chapter 2, *Proposed rules clarifying the scope of the PRIIPs regime in the UK*, in FCA Consultation Paper 21/23, *PRIIPs - Proposed scope rules and amendments to Regulatory Technical Standards* (the "**consultation**") from the perspective of the primary international bond (Eurobond) markets.

2. **Focus not on KID content (due to KID concept concerns)** – No comments are expressed on the questions set out in Chapter 3 (*Information on performance and overall risk*) and in Chapter 4 (*Technical amendments to transaction costs disclosure requirements*) of the consultation. This is because Eurobond transactions are in practice structured to fall outside the scope of the PRIIPs regime, due to conceptual concerns as set out in #2(c) and #13-15 of the September 2018 ICMA response to FCA's *Call for Input: PRIIPs Regulation - initial experiences with the new requirements* (the "**ICMA CfI response**"). The ICMA CfI response flagged certain KID content concerns

incidentally, but ICMA has discontinued focus on these aspects pending indication that the threshold conceptual concerns are likely to be addressed.

Chapter 2: Proposed rules clarifying the scope of the PRIIPs regime in the UK

Q1: Do you agree with our proposed rules to clarify the scope of the PRIIPs regime?

3. **Formal comfort** – It is helpful that the FCA is effectively trying to formalise, in the context of the on-shored UK PRIIPs regime and via the creation of the new Product Disclosure ("**DISC**") sourcebook, comfort given in the October 2019 joint ESAs' supervisory statement (the "**ESA's 2019 statement**") that has been limited by its unavoidably informal, non-binding nature.

4. **Limited substantive scope** – However, the ESAs' 2019 statement was also limited in its substantive scope. There did not seem to be much point flagging this at the time, given its informal / non-binding nature and the then expectation of the imminence of the EU's scheduled formal review of the PRIIPs regime. Like the proposed FCA comfort, the ESAs' 2019 statement followed a 'granular' approach to scope clarification (focusing on selected specific product characteristics), following on from the preceding July 2018 ESAs' letter to the European Commission. #6 of the ICMA CfI response acknowledged that some clarifications arose from this granular approach, but it also proposed at #7 an alternative 'conceptual' approach to scope guidance – in case one wished to avoid extended debate about individual granular features and which several large law firms active in the field of vanilla bond issuance believed would significantly facilitate legal advisers' ability to advise their borrower clients that vanilla bonds are outside the PRIIPs regime's product scope. Furthermore, the substantive perimeter of the proposed FCA comfort seems to exclude some aspects that were covered by the ESAs' 2019 statement – see event-driven steps in #11 below[1] (as well as the response to Q2 below more generally regarding several specific aspects seemingly left out of the FCA's current comfort proposals).

5. **'Coming between' ('Intercession')** – It is comforting though that the FCA believes in the fundamental relevance of the concept of 'coming between'/'intercession', by generally distinguishing *"nonpackaged, direct investment"* from a *"return […] substantially determined by the performance of investment assets the investor does not purchase"* and specifically stating that *"To be a PRIP, a debt security must come between the retail investor and an ultimate investment asset which is not purchased by the investor."* This is consistent with Recital 6 of the PRIIPs Regulation, which states the PRIIPs regime should apply to products that *"intercede"* between retail investors and the markets.

6. **'Complexity**' – However, the FCA's suggestion[2] that the complexity of an instrument is relevant to whether or not it is packaged contradicts the FCA's general 'coming between' approach (that to be packaged a debt security must come between the retail investor and an ultimate investment asset). The FCA already has regulation that deals with instruments that are complex and in particular the PROD sourcebook.

[1] Comparing the comfort proposed by the FCA with that in the ESAs' 2019 statement is challenging (both being 'granular' but articulated in different ways) and the cases noted here may not be the only ones. (And 'granular' approaches are in any case more challenging in terms of future-proofing for new product structures, as exemplified in #12 regarding SLBs.)

[2] Paragraph 2.15(b) of the consultation: *"…better regarded as a packaged investment due to their complex features".*

Q2: Are there remaining areas of ambiguity in the scope of the PRIIPs Regulation which would not be addressed by the proposed rules, and if so, which?

7. The FCA's proposed list of neutral features in draft DISC 2.2.4 seems unhelpfully to exclude certain common features of bonds that do not involve a debt security 'coming between' an investor and an ultimate investment asset and therefore should not deemed packaged. Specifically, the list of neutral features should accommodate (i) voluntary call options, (ii) non-NPV par calls, (iii) floating rate coupon steps, (iv) event-driven coupon steps (including sustainability-linked bonds) and (v) caps and non-zero floors – to provide certainty that bonds with these features are not PRIIPs.

8. **Voluntary call options** – Draft DISC 2.2.4R(4) would clarify that an issuer call option (at or above par) would not cause a security to be 'packaged' under the PRIIPs regime. But this would only cover such an option exercisable further to specific developments (as set out in draft DISC 2.2.4R(4)(a)), and not such an option exercisable at the issuer's discretion. Many vanilla bonds include call options at issuer discretion within certain limits, whether subject to a make-whole provision or merely at par (usually in last three months or so preceding redemption, to mitigate refinancing risk related to market volatility around scheduled maturity). These bonds should not be excluded from the proposed list of neutral features, because fundamentally they involve no 'coming between' (see #5 above).

9. **Non-NPV par calls** – Draft DISC 2.2.4R(4) seems to include par calls as well as make-whole calls at or above par. However draft DISC 2.2.4R(4)(b) then inconsistently requires disclosure of an NPV mechanism, which would be inapplicable for a straight par call. These bonds should not be excluded from the proposed list of neutral features, because fundamentally they also involve no 'coming between' (see #5 above). Replacing *"the mechanism"* with *"any mechanism"* in draft DISC 2.2.4R(4)(b) should help address this apparent inconsistency.

10. **Floating rate steps** – Draft DISC 2.2.4R(1)(b) would clarify that pre-defined coupon steps would not cause a security to be 'packaged'. But it provides that this would only be the case in the context of fixed rate bonds, with no equivalent provision under draft DISC 2.2.4R(2) for floating rate bonds, where the spread over the relevant benchmark might include a step provision. These bonds should not be excluded from the proposed list of neutral features, because fundamentally they also involve no 'coming between' (see #5 above).

11. **Event-driven steps** – Draft DISC 2.2.4R(1)(b)'s clarificatory comfort is also limited to coupon steps that are set to occur mechanically *"at fixed times"*, whilst the ESA's 2019 statement explicitly includes event-driven steps (*"ratings downgrade of the issuer, change of control event, or tax or regulatory event"*) as falling outside the product scope of PRIIPs. These bonds should not be excluded from the proposed list of neutral features, (i) because fundamentally they too involve no 'coming between' (see #5 above) and (ii) to ensure the product scope of UK PRIIPs regime is not wider than the product scope of the EU PRIIPs regime. Deleting *"at fixed times"* in draft DISC 2.2.4R(1)(b) should help address this.

12. **Sustainability-linked bonds** ("**SLBs**") – Draft DISC 2.2.4R(1)(b) would also not cover SLBs, where coupon steps are event-driven (being contingent on the issuer failing to meet certain ESG key performance indicators). Admittedly sustainability-linked steps were not included in the ESA's 2019 statement with the other event-driven steps. But this should be seen as intentional, since SLBs did not really exist at that time: the first ever SLB was only issued in the month preceding publication of the ESA's 2019 statement and there was no further issuer until around 11 months

after its publication.[3] Sustainability-linked steps should not be excluded from the proposed list of neutral features, because (i) fundamentally they too involve no 'coming between' (see #5 above); and (ii) it is unclear how excluding SLBs from such comfort fits with public policy aims relating to sustainable finance. Again, deleting *"at fixed times"* in draft DISC 2.2.4R(1)(b) should help address this.

13. **Caps and non-zero floors** – Draft DISC 2.2.4R(2)(b) would explicitly carve-out from the list of neutral features those floating rate instruments that have a cap or a floor other than zero. These bonds should also benefit from formal FCA comfort as to falling outside the product scope of PRIIPs, as fundamentally they too involve no 'coming between' (see #5 above). (This inconsistency was equally present in the ESA's 2019 statement – but was just not worth flagging as explained in 4 above.)

Q3: Do you agree with the proposed guidance on conditions for a PRIIP to be regarded as not made available to retail investors?

14. The proposed guidance is disproportionately narrow in several ways and needs to be refined to have material value in terms of comfort.

15. **Unconnected secondary market *"distributors"*** – First, in Draft DISC 2.3.1G(2), the reference to *"secondary market offers"* by a *"distributor"* needs to be clearly understood to exclude any persons unconnected to the issuer *"manufacturer"*. This is because *"making available"*, as the trigger for a manufacturer obligation (the production and maintenance of a KID), should intrinsically involve that manufacturer. The PRIIPs legislation does not use the term "distributor" – rather requiring any person advising on, or selling, a PRIIP to pass on the manufacturer KID (the absence of such a KID thus amounting to a statutory prohibition on retail sales of in-scope products). However, the MiFID II legislation has created the potential for confusion in naming as *"distributors"* for the purposes of the product governance regime any persons that *"offer or sell"*, or *"offer or recommend"*, financial instruments (with no connection to the MiFID II *"manufacturer"* being explicitly required). It would be fundamentally unjust if the illegal secondary market selling of PRIIPs to retail investors by third parties, either unknown to the issuer or over which it has no control, caused that issuer to be in technical breach of an obligation to produce a KID.

16. **Eligible investors and minimum denomination / alternative rather than cumulative requirements** – The cumulative nature of the eligible investor requirement in Draft DISC 2.3.1G(2) and the minimum denomination requirement in Draft DISC 2.3.1G(3) reduces stakeholders' comfort perceptions and is inconsistent with the approach taken in related financial services regulation and therefore creates an incoherent rulebook, unnecessary complexity and costs for market participants. Broadly speaking, stakeholders are currently comfortable that, combined with some appropriate legending, the avoidance by issuer-controlled parties of retail-specific marketing and of direct retail access facilitation (such as admission to a direct retail trading platform) should not be reasonably seen as *"making available"* – bearing in mind also that the absence of a KID amounts to a statutory prohibition on retail sales of in-scope products. The proposed FCA comfort would be narrower than this current view and is likely to result in the FCA not achieving the outcome it is seeking in paragraph 1.26 of the consultation (*"to promote liquidity and choice in the retail bond market"*). Rather, the minimum denomination requirement and the eligible investor requirement should each just be alternative requirements to each other – and cumulative only to the legends requirement in Draft DISC 2.3.1G(1). This would also be

[3] This being illustrative of how 'granular' approaches to PRIIPs product scope are more challenging in terms of future-proofing for new product structures.

consistent with the approach to exemptions from the UK's public offering rules that seem likely to be adopted further to the July 2021 HMT *UK Prospectus Regime Review* consultation (the "**HMT prospectus consultation**") that ICMA has responded to – where exemptions such as those related to minimum denominations and offers addressed solely to qualified investors are alternative rather than cumulative.

17. **Minimum denomination calibration / alignment to prospectus regime** – Beyond being non-cumulative, the specific calibration of the minimum denomination requirement in Draft DISC 2.3.1G(3) should also align with the outcome of the HMT prospectus consultation.

18. **Eligible investor definition / alignment to prospectus regime** – Beyond being non-cumulative, the eligible investor requirement in Draft DISC 2.3.1G(2) should, for debt securities / bonds, also align with the qualified investor exemption outlined paragraph 7.14 in the HMT prospectus consultation (as it is unhelpful to use two different terms - *"qualified investor"* on the one hand and *"professional clients and eligible counterparties"* on the other hand - to cover a single idea).

19. Should the FCA wish to consider wider, 'blue sky', thinking around the 'retail' scope of the UK PRIIPs regime, this would need to involve detailed discussions that ICMA would be willing to participate in.

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