
Consultation response

PRIIPs Regulation/Response to FCA Call for Input

27 September 2018

AFME welcomes the opportunity to respond to the FCA's Call for Input: PRIIPS Regulation - initial experiences with the new requirements, published in July 2018. We note (paragraph 1.10) that the FCA is undertaking a thematic supervision project, which includes an assessment of compliance with the PRIIPs Regulation.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate for stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is registered on the EU Transparency Register, registration number 65110063986-76.

AFME wishes to respond to the Call for Input ("CFI") by:

- (a) commenting on certain statements made in Chapter 2 on the scope of PRIIPs Regulation;
- (b) responding to questions 1 and 2 in Annex 1; and
- (c) providing commentary on the considerations set out in the Annex to the letter dated 19th July sent by the European Supervisory Authorities to the European Commission.

(a) Our comments on the statements made in Chapter 2 of the CFI are as follows.

- we agree with the assessment that there is industry concern about how to interpret the scope of the PRIIPs Regulation correctly. This concern has been expressed to us by our members as well as by associations across the European Union representing underwriting banks, wealth managers, issuers and investors;
- in particular, we agree with the statement in paragraph 2.8 that it is unclear whether bonds with certain features are in or out of scope; and
- we further agree with the statements that: (a) firms are avoiding issuing certain bonds to retail investors in the primary market; and (b) distributors are stopping sales of corporate bonds to retail investors in the secondary market. In the view of our members both (a) and (b) are taking place and the feedback we received in the first months following implementation is summarised in a paper (attached) entitled "Impact of the PRIIPs Regulation on Retail Activity in Corporate Bonds", which was finalised in March 2018.

(b) Our response to Questions 1 and 2 of the CFI is as follows.

1. *Are you experiencing problems with clarifying the scope of the PRIIPs Regulation? Please provide examples of product types where you believe there is uncertainty.*
2. *Have you tried to resolve this uncertainty and faced difficulties in doing so? If so, please provide details and examples of the difficulties you have faced.*

Yes. AFME members and their advisers have reported that, although the PRIIPs regime was intended to capture “packaged” products only (as set out in Recital (6) of the PRIIPs Regulation), the ambiguous nature of the wording of Article 4(1) (where a PRIIP is defined as an instrument which “is subject to fluctuations because of exposure to reference values or to the performance of one or more assets not directly purchased by the retail investor”) means that a bond with terms and conditions which typically contain provisions such as make-whole call options, certain change of control puts, index-linked and capital features and interest rate step-up/down mechanics, caps and floors could be considered to be a PRIIP.

AFME members have also reported that questions have been raised with respect to whether an equity rights issue might fall under the definition for an instrument that could a PRIIP.

AFME members have noted that no regulatory guidance was issued in advance of or since the introduction of the Regulation, which addresses this issue in a comprehensive way. Given the uncertainty and the high level of potential fines for a manufacturer which does not comply with the requirement to produce a KID, issuers and their advisers have taken a cautious view such that any bond that does not have completely fixed returns may be a PRIIP. The result has been that issuers have designated almost all new issues as not intended for retail, rather than consider whether the product is a PRIIP and, if so, prepare a KID.

This had the following impact from the beginning of 2018:

- i. issuers are not issuing certain types of bonds to retail investors in the primary market;
- ii. distributors are not able to sell certain types of bonds to retail investors in the secondary market, due to the lack of an available KID;
- iii. relatively standard, often investor protective, clauses are being removed from bond deals to permit them to be made available to retail investors;
- iv. retail investors are generally unable to access the primary or secondary corporate bond market unless via a discretionary managed channel, thereby introducing intermediary costs and restricting access to those retail investors who are willing to pay such costs on an ongoing basis and have sufficient assets to access discretionary portfolio management services;
- v. connected to the above, retail clients are being limited to indirect investments in bond markets via collective investment schemes, structured products or the occasional bond that has either: 1) been stripped of the investor protective features (such as inflation-linked principal and interest, make-whole call options and some change of control put options); or 2) has, in a few cases, been issued with a PRIIPs KID;

- vi. in some cases, retail investors are unable to divest from or roll-over from existing bond holdings (issued pre-1 January 2018). For example:
 - (i) banks with retail customers cannot facilitate the onward sale or purchase to other retail investors, meaning that existing investors must hold these investments to maturity or sell to professional investors who are prepared to stock up on these investments through a number of purchases from retail and then on-sell to other professional investors; and
 - (ii) retail investors are being excluded from exchange offers which are being offered to existing bondholders on more favourable terms, leaving professional investors with the ability to exchange to the favourable bond terms whilst retail investors are left holding the rump issuance with no ability to divest.

More recently (since July 2018), AFME members have confirmed (in line with the initial feedback collated in Q1 2018 and summarised above) that:

- the lack of clarity as to the scope is continuing to cause confusion and that this is leading to an ongoing shrinkage of availability of bonds for retail investors in the primary market;
- retail client secondary market activity has been reduced very significantly since 1 January and this will, if there is no change, lead to the direct retail market ceasing to exist;
- with respect to pre-2018 bonds (for which no KID is available), there has been an increase in the incidence of retail investors deciding not to sell such bonds and following a hold to maturity strategy. This means that they may hold onto potentially unsuitable names whose credit might deteriorate over time;
- the ambiguity has also had an impact on the purchase and sale of bonds issued outside the EU. Regular fixed income instruments with one or more of the above features are common in the US bond market. These “simple” bonds are being classified as potential PRIIPs but have no KIDs and therefore EU based retail investors who wish to diversify away from EU markets are not able to do so; and
- with respect to pre-2018 issuance, our members have reported that from January 2013 until January 2018, there have been 1,277 investment grade bond tranches (in EUR, GBP and USD amounting to approx. USD 932bn) containing make-whole clauses and 2,841 tranches (amounting to approx. \$1.6 tn) where there is a call feature. This is out a total of 11,824 tranches totalling \$4.8tn.

In summary, the overall impact of the uncertainty as to the scope of the PRIIPs regulation has been to reduce choice for retail investors unnecessarily as well as increasing the cost to issuers of raising finance and reducing the diversity of the investor base. The uncertainty has affected a significant proportion of the existing stock of bonds (as noted above).

AFME also would like to make the following points which are relevant when considering the uncertainty as to the scope of the PRIIPs Regulation:

- the key term of “manufacturer” is not defined in the PRIIPs Regulation. The only explanatory guidance included in Recital 12 of the Regulation does not contemplate non-financial issuers being manufacturers: “*PRIIP manufacturers — such as fund managers, insurance undertakings, credit institutions or investment firms...*” The working assumption in the market is that the issuer (including a non-financial issuer) of a debt instrument will be the manufacturer. Given the lack of contemplation in the PRIIPs Regulation for unregulated entities falling within scope, corporate issuers are left with uncertainty as to their legal and regulatory risk should they seek to produce a KID for their bonds. The majority of corporate issuers will not have a national competent authority directly regulating them. It is therefore very difficult to determine the precise scope of any regulatory risk by reference to a particular National Competent Authority’s implementation of the PRIIPs Regulation, which further increases uncertainty. Given this uncertainty many corporate issuers are unwilling to take on the liability of KID production;
- Article 2(2)(d) of the PRIIPS Regulation states that the PRIIPS Regulation shall not apply to the products referred to in points (b) – (g), (i) and (j) of Article 1(2) of the Prospectus Directive. The Prospectus Directive has been repealed and replaced with the new Prospectus Regulation, which contains much the same content as article 1(2) of the Prospectus Directive in this context. The PRIIPS Regulation therefore excludes from scope, by virtue of the fact it was contained at Article 1(2) of the Prospectus Directive (now Article 1(2) of the Prospectus Regulation), all instruments matching the below description:
 - (b) “Non-equity securities issued by a Member State or by one of a Member State’s regional or local authorities, by public international bodies of which one or more Member States are members, by the European Central Bank or by the central banks of the Member States.”

Since the above definition also captures “non-equity securities issued by public international bodies of which one or more Member States are members”, the industry has construed this as including supranational bonds. However, AFME members would welcome confirmation of this interpretation.

(c) Annex to the letter dated 19th July sent by the European Supervisory Authorities to the European Commission

In correspondence to and meetings with the ESAs and the Commission, AFME has highlighted the above issues and asked for action to be taken to assist the industry. In this context AFME welcomes the letter from the ESAs to the European Commission dated 19th July 2018. In general, we agree with the approach taken and we have added our commentary directly into the attached table (see attached).

AFME members would welcome the ESAs’ analysis (taking account of our input) being formalised by way of guidance as soon as possible and, in any event, prior to any review of the PRIIPs Regulation. In our view, the lack of clarity as to scope is an issue which requires urgent attention and is a discrete area of concern/unintended impact, which could be addressed by guidance issued by the ESAs (with the support of the Commission). We believe that early action of this

nature would mitigate some of the ill effects we have set out above and would allow the regulators (and industry) to focus on the other issues relating to the form and content of the KID as part of a general review of the working of the PRIIPs Regulation.

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