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Key Implications of the EU's new PRIIPs and MiFID II Regimes for Offerings of Debt Securities

Introduction

Two new European regulatory regimes came into force in January 2018, bringing about sweeping changes for many market participants involved in offers and sales of financial instruments in Europe. On January 1, the European Union (the “EU”) Regulation on Key Information Documents for Packaged Retail and Insurance-based Investment Products¹ (the “PRIIPs Regulation”) became directly applicable in all member states of the European Economic Area (the “EEA”). The EU’s revised Markets in Financial Instruments Directive² (“MiFID II Directive”) and the new Markets in Financial Instruments Regulation³ (“MiFIR,” and together with the MiFID II Directive, “MiFID II”) took effect in all EEA member states in January as well.

The PRIIPs Regulation is designed to enhance retail investors’ understanding of key features and risks associated with packaged retail and insurance-based investment products (“PRIIPs”) by imposing certain disclosure obligations on manufacturers of such products. MiFID II is aimed at improving transparency and strengthening investor protections in the EEA markets through, among other things, the modification and expansion of transparency and reporting requirements for banks and broker-dealers.

We discuss below certain aspects of the new regimes that are of relevance to offerings of debt securities, including offerings of high-yield bonds. We do so with the benefit of a few months of experience with both of the regimes.

Key Implications of the PRIIPs Regime

The PRIIPs Regulation requires persons that “manufacture,” advise on or sell PRIIPs to provide a key information document (a “KID”) whenever a PRIIP is “made available”⁴ to retail investors in the EEA

¹ Regulation (EU) No 1286/2014, available [here](#).

² Directive 2014/65/EU, available [here](#).

³ Regulation (EU) No 600/2014, available [here](#).

⁴ A PRIIP is “made available” when it is marketed, offered and sold as well as upon entering into a bilateral contract in relation to a PRIIP with a retail investor. Manufacturers of a PRIIP are required to publish a KID *before* the PRIIP is made available to retail investors, while persons advising on, or selling, a PRIIP are required to provide a KID to retail investors *in good time before* such retail investors are bound by any contract or offer.

(regardless of where the PRIIP originated). While it is expected that most offerings of debt securities (in particular, so-called plain vanilla debt securities) would be exempt from the application of the PRIIPs Regulation due to the debt securities not being categorized as PRIIPs and/or being offered only to non-retail investors, there may, however, be instances where such an offering could fall within the scope of the PRIIPs Regulation. This could occur either due to the broad scope of the PRIIPs products definition or due to PRIIPs manufacturers not always being in control of primary or secondary sales of the product, which may result in the PRIIPs being sold to retail investors in the EEA, triggering the requirement for a KID.

What is a PRIIP?

A PRIIP is “an investment ... where, regardless of the legal form of the investment, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets that are not directly purchased by the retail investor.” The PRIIPs Regulation expressly identifies certain financial products to which it does not apply, such as investment funds dedicated specifically to institutional investors, assets held directly by retail investors and products where the rate of return is fixed in advance for the entire life of the product, as well as basic banking products that contain no element of packaging (such as deposit accounts). The list, however, is not exclusive.

In the context of offerings of debt securities, the broad scope of the PRIIPs definition contributes to a high level of uncertainty regarding the potential categorization of certain types of debt securities as PRIIPs. While most market participants would consider plain vanilla debt securities (*i.e.*, debt securities with a fixed interest rate, defined maturity, redemption at par and no special features (such as early redemption)) as not covered by the PRIIPs Regulation because the amount repayable to investors is not subject to fluctuation, they are of the view that more complex debt securities (such as those with floating rates or with special features like a make-whole redemptions even if paid at fixed rate coupon and par at maturity⁵) could be more likely categorized as PRIIPs because of the potential for repayments on such debt securities to be subject to fluctuations (even if only in limited situations). The lack of guidance from the European Securities and Markets Authority (“ESMA”) on this issue has resulted in a market view that a more complex analysis may need to be applied to certain types of debt securities when trying to determine whether they fall within the scope of the PRIIPs Regulation.

If a debt instrument is determined not to fall within the PRIIPs definition, the manufacturer(s) of the instrument (*i.e.*, the issuer, the underwriters and other market participants involved in the offering) would not be obligated to comply with the PRIIPs Regulation requirements. However, if there is a possibility that the instrument could be categorized as a PRIIP, then the instrument’s manufacturer(s)

⁵ Some market participants would still categorize these types of bonds as more complex plain vanilla bonds.

would be required to prepare a KID prior to the instrument being made available to EEA retail investors, unless one can be confident that the instrument would not be sold to such investors.

Who are retail investors?

Under the PRIIPs Regulation retail investors include (i) persons in the EEA classified as “retail clients” under MiFID II (*i.e.*, non-professional clients⁶) and (ii) persons in the EEA classified as “customers” under the EU Insurance Mediation Directive.⁷

Market participants should be mindful that the definition of retail under the PRIIPs Regulation does not correspond to the definition of retail under the EU Prospectus Directive.⁸ As a result, debt securities that are considered “wholesale” under the EU Prospectus Directive (*i.e.*, those with denominations of at least €100,000) may still be covered under the PRIIPs Regulation because whether a PRIIP is retail or not depends purely on the regulatory classification of potential purchasers.

Should a debt instrument offered to retail investors be found to be a PRIIP, the instrument’s manufacturer would be required to prepare a KID prior to the instrument being made available to such investors and to review and update regularly the information contained in the KID during the time period the debt instrument remains outstanding. The Level 2 PRIIPs Regulation sets out a template for the KID (which should be no longer than three pages) and details the prescriptive requirements as to the information that the KID should contain. Issuers have an obligation to prepare a KID outlining the key features of the PRIIP they manufacture or to confirm suitability of investors to acquire the PRIIP.

The preparation and distribution of a KID may prove to be a burdensome obligation for many PRIIP manufacturers. Additionally, this requirement could potentially subject such persons to liability if a retail investor suffers loss due to the fact that (i) the KID is inconsistent with binding pre-contractual and contractual documentation, (ii) the KID is misleading or inaccurate or (iii) the KID fails to comply with prescribed form and content requirements.

⁶ The definition of “professional clients” under MiFID II encompasses clients that are professional by their status (*e.g.*, financial institutions, pension funds, governments, central banks or certain large entities) or retail clients that elect to be treated as professional clients. For a retail client to be treated as a professional client, it must meet certain qualitative and quantitative criteria that would show that such client is capable of making the investment decision and understanding the risks involved.

⁷ Directive 2002/92/EC, available [here](#). As of February 23, the EU Insurance Mediation Directive has been replaced by the EU Insurance Distribution Directive (Directive 2016/97/EC), available [here](#).

⁸ Directive 2003/71/EC, available [here](#).

Key Implications of MiFID II Product Governance Regime

MiFID II establishes a new product governance regime designed to enhance the level of investor protection in EEA markets through, among other things, the modification and expansion of transparency and reporting requirements for banks and broker-dealers. The regime requires persons that manufacture or distribute financial instruments to have in place a specified process for approval of each financial instrument. Manufacturers must identify a compatible target market of investors for each financial instrument and assess all risks relevant to the identified target market in order to ensure that the financial instrument and the intended distribution strategy are consistent and compatible with the needs, characteristics and objectives of the identified target market. Manufacturers of financial instruments are required to provide distributors with relevant information on the identified target market in order for the distributors to understand and distribute the financial instruments properly. Additionally, distributors must also identify their own target market. The product governance regime is to be complied with in an “appropriate and proportionate” way, meaning that the less sophisticated the identified target market, the more extensive the disclosure and review processes that need to be applied, while the more sophisticated the target market (for example, one that only includes professional investors), the less complex the disclosure.

Investment firms are treated as “manufacturers” if they “create, develop, issue and/or design financial instruments, including when advising corporate issuers on the launch of new financial instruments.” “Distributors” for purposes of the MiFID II product governance regime are persons that “offer, recommend or sell financial instruments” to clients (with no connection to the manufacturer being required). The MiFID II product governance regime applies directly only to investment firms that are established in the EEA and are subject to MiFID II; however, indirectly it could also have an impact on non-MiFID II firms that do business with MiFID II firms (for example, non-EEA established investment firms that extend their financial instruments’ sales to EEA markets) or that purchase products that only tangentially are related to EEA products (for example, purchasing shares of a company that has a secondary listing in the EEA).

In the context of offerings of debt instruments, the MiFID II product governance regime is likely to impact the related offering documentation, as the lead manager acting as adviser to the issuer on the offering would be treated as the manufacturer under MiFID II and, as such, required to establish and maintain adequate policies and arrangements for approval of the debt securities before they are marketed and distributed to an identified target market of end clients, and for periodic review of the target market and performance of any debt instruments being offered. In cases where the lead manager is not a MiFID II firm (for example, by virtue of being an investment firm not established in the EEA) but another manager or distributor is a MiFID II firm, then that other manager or distributor would be obligated to seek information from the lead manager.

Considerations for the KID and Product Governance Regimes

PRIIPs manufacturers not wishing to prepare a KID might consider the following potential mitigating solutions:

- inserting contractual provisions prohibiting sales in the EEA to retail investors and prohibiting retail investors from holding unsuitable products;
- putting in place distribution arrangements and agreements with product purchasers under which they agree not to sell to purchasers in the EEA; and
- placing legends on the product that state that the product is not intended for offer, sale or distribution to retail investors in the EEA – *see Annex I* for ICMA’s suggested selling restrictions and legends for plain vanilla debt securities for both stand-alone issuances and debt programs.

MiFID II firms that would like to limit the disclosure requirements imposed by the MiFID II product governance regime might aim to limit the identified target market for their financial instruments to more sophisticated investors (*i.e.*, professional clients) by including relevant legends and selling restrictions (similar to those prepared by ICMA in context of the PRIIPs Regulation – *see Annex I*) in their offering documentation and using high denominations.

Other Provisions of MIFID II Impacting Offerings of Debt Securities*Disclosure of bank fees*

MiFID II introduces new fee disclosure requirements that impose an obligation on banks to disclose fees they charge for arranging transactions in financial instruments, including debt securities, in the EEA. The fee disclosure requirements affect not only offerings in Europe, but also combined Regulation S/144A offerings (*i.e.*, having a U.S. tranche). Interpretive questions that have arisen include:

- Do the rules apply to offerings in which a non-EEA bank is engaged in a securities offering on behalf of a non-EEA issuer but where some of the securities are distributed in an EEA member state?
- Do the rules require banks to disclose side letters that cover the payment of extra fees for certain banks in the syndicate?
- Do the rules provide for any carve-outs for the primary bond markets?

Enhanced pre-trade and post-trade price transparency obligations

Compared with the previous EU regime, MiFID II expands the scope of the pre- and post-trade transparency framework to include not just equity but also equity-like (*i.e.*, depositary receipts, ETFs and certificates) and non-equity (*i.e.*, bonds, structured finance products, emission allowances and traded derivatives) financial instruments. The MiFID II regime is designed to ensure greater transparency and protection for investors by, among other things, refocusing efforts on obtaining the best available price for the trades. More specifically, the new pre-trade transparency requirements require making public bids and offer prices, while the extended post-trade transparency obligations call for public disclosure of the price, volume and time for each covered financial instrument. Under both pre- and post-trade transparency obligations, disclosure must be made on a reasonable commercial basis as close to the real time as is technically possible. There are waivers available for pre-trade disclosure and deferrals for post-trade disclosure requirements, which – for example, in the context of debt securities – apply if a market for a debt security is determined to be illiquid (based on the average daily notional amount, the average daily number of trades or the percentage of days an instrument traded in the assessment period) or if it falls within a certain trade size threshold, with the national competent authorities having the discretion to choose which waiver to apply. On April 18, ESMA published an update⁹ to its liquidity assessment for bond instruments,¹⁰ which shows that less than 2% of debt securities (772 instruments out of 68,974 analyzed) were sufficiently liquid to fall under pre- and post-trade transparency rules. However, the definition of liquidity for purposes of whether the MiFID II transparency requirements apply or not in respect of a particular debt security is subject to gradual expansion so that, increasingly over time, a greater number of debt securities will be subject to the requirements.¹¹

In connection with offerings of debt securities, the enhanced transparency obligations are likely to result in significantly more information about trades being required to be reported immediately and to be stored for much longer, increasing the compliance burden and cost for investment firms. While in the past firms were allowed to agree among themselves as to which firm would be responsible for complying with the pre- and post-trade disclosure obligations, under the MiFID II disclosure rules, such agreements are not allowed and the sell-side is obligated to undertake the disclosure unless the buy-side is the systemic

⁹ ESMA update to its MiFID II transitional transparency calculations (TTC) for bonds, available [here](#).

¹⁰ The assessment was conducted in accordance with the transparency requirements for non-equity instruments established under Commission Delegated Regulation (CDR) 2017/583, available [here](#).

¹¹ For example, during Stage 1 as currently in effect until July 30, 2019, an instrument is considered liquid if it is the subject of at least 15 average daily trades; under Stage 2 the average daily trades requirement will decrease to 10, under Stage 3 to seven and under Stage 4 to two). Each stage after Stage 1 is to be in effect for one year. See Commission Delegated Regulation (CDR) 2017/583, available [here](#).

internalizer¹² for the class of securities. The rules require investment firms that are systemic internalizers to provide quotes when prompted by clients, make such quotes available to other clients in an objective, non-discriminatory way and enter into transactions at or below a size specific to the instrument subject to any limits they may set on the number of transactions at any price. Systemic internalizers are also subject to an expanded (both in scope and prescription) post-trade obligation to report full transaction details to regulators on a T+1 basis, using an Approved Reporting Mechanism (ARM).

As a result of the enhanced transparency rules, bond trading may gradually and increasingly move to electronic platforms, making it easier for regulators to monitor, which ultimately may affect the liquidity and volume of bond transactions. The full extent of the impact of the new transparency obligations on bond offerings is currently unclear and will take time to emerge.

Disclosure of final bond allocation

MiFID II imposes a new obligation on banks and broker-dealers to provide justification for the final allocation to investors in cases of oversubscribed sales. While most banks already have strict procedures on how to allocate debt securities, under MiFID II rules they are required to update and enhance those procedures and provide summaries of compliance in a timely manner and in a format that facilitates regulatory review.

The allocation rules have proven challenging in the context of European high-yield bond offerings. In investment-grade bond syndications, banks acting as underwriters engage in reconciliation whereby they take orders and collate them at the end, removing any duplicates, with the process culminating in a final allocation call. For high-yield bonds, the practice is different, since most underwriters follow the U.S. practice whereby the left-lead underwriter effectively controls the deal and has full responsibility for how the deal is allocated to investors.

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¹² A “systemic internalizer” is an investment firm which, on an organized, frequent systematic and substantial basis, acts for its own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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Annex I

PRIIPs Regulation: ICMA suggested standalone selling restriction (ICMA1)

Prohibition of Sales to EEA Retail Investors

Each Manager has represented and agreed that it has not offered, sold or otherwise made available and will not offer, sell or otherwise make available any [Notes] to any retail investor in the European Economic Area. For the purposes of this provision:

- the expression “retail investor” means a person who is one (or more) of the following:
 - a retail client as defined in point (11) of Article 4(1) of Directive 2014/65/EU (as amended, “MiFID II”); or
 - a customer within the meaning of Directive 2002/92/EC (as amended, the “Insurance Mediation Directive”), where that customer would not qualify as a professional client as defined in point (10) of Article 4(1) of MiFID II; or
 - not a qualified investor as defined in Directive 2003/71/EC (as amended, the “Prospectus Directive”);¹³ and
- the expression “offer” includes the communication in any form and by any means of sufficient information on the terms of the offer and the [Notes] to be offered so as to enable an investor to decide to purchase or subscribe the [Notes].¹⁴

¹³ The three limbs and paragraph below have been included to ensure it is clear how both the PD public offer regime (for securities with a denomination of less than EUR 100,000 or equivalent) and the PRIIPs Regulation are being addressed.

¹⁴ Because a PD selling restriction is not required for issues of bonds with a denomination of EUR 100,000 (or equivalent) or more, paragraphs which relate to the PD public offer regime do not need to be included for issues of bonds with a denomination of EUR 100,000 (or equivalent) or more.

MiFID II PG/PRIIPs Regulation legends (ICMA1)**Long-form – For prospectuses and other documents¹⁵**

- **MIFID II product governance / Professional investors and ECPs only target market –** Solely for the purposes of [the/each] manufacturer’s product approval process, the target market assessment in respect of the [Notes] has led to the conclusion that: (i) the target market for the [Notes] is eligible counterparties and professional clients only, each as defined in [Directive 2014/65/EU (as amended, “MiFID II”)] [MiFID II]; and (ii) all channels for distribution of the [Notes] to eligible counterparties and professional clients are appropriate. Any person subsequently offering, selling or recommending the [Notes] (a “distributor”) should take into consideration the manufacturer[’s/s’] target market assessment; however, a distributor subject to MiFID II is responsible for undertaking its own target market assessment in respect of the [Notes] (by either adopting or refining the manufacturer[’s/s’] target market assessment) and determining appropriate distribution channels.
- **[PRIIPs Regulation [/ Prospectus Directive]¹⁶ / Prohibition of sales to EEA retail investors** – The [Notes] are not intended to be offered, sold or otherwise made available to and should not be offered, sold or otherwise made available to any retail investor in the European Economic Area (“EEA”). For these purposes, a retail investor means a person who is one (or more) of: (i) a retail client as defined in point (11) of Article 4(1) of Directive 2014/65/EU (as amended, “MiFID II”); or (ii) a customer within the meaning of Directive 2002/92/EC (as amended, the “Insurance Mediation Directive”), where that customer would not qualify as a professional client as defined in point (10) of Article 4(1) of MiFID II; or (iii) not a qualified investor as defined in Directive 2003/71/EC (as amended, the “Prospectus Directive”).¹⁷ Consequently no key information document required by Regulation (EU) No 1286/2014 (as amended, the “PRIIPs Regulation”) for offering or selling the [Notes] or otherwise making them available to retail investors in the EEA has been

¹⁵ This drafting relates to ‘standalone’ bond issuance. Consideration will need to be given to adapting this language for a debt issuance programme and related drawdowns.

¹⁶ Because a PD selling restriction is not required for issues of bonds with a denomination of EUR 100,000 (or equivalent) or more, this reference to the Prospectus Directive does not need to be included for issues of bonds with a denomination of EUR 100,000 (or equivalent) or more.

¹⁷ Because a PD selling restriction is not required for issues of bonds with a denomination of EUR 100,000 (or equivalent) or more, the third limb of the definition of retail investor (which relates to the PD public offer regime) does not need to be included for issues of bonds with a denomination of EUR 100,000 (or equivalent) or more.

prepared and therefore offering or selling the [Notes] or otherwise making them available to any retail investor in the EEA may be unlawful under the PRIIPS Regulation.]¹⁸

Short-form – For new issue announcements

- **MiFID II professionals/ECPs-only [/ No PRIIPs KID]**¹⁹ – Manufacturer target market (MiFID II product governance) is eligible counterparties and professional clients only (all distribution channels). [No PRIIPs key information document (KID) has been prepared as not available to retail in EEA.]²⁰

Very short-form – If needed by any third party market/trading screens

- MiFID II professionals/ECPs-only [/ No PRIIPs KID]²¹

MiFID II PG legends for retail debt securities (ICMA2)

Long-form – For prospectuses, final terms and other documents²²

- **MiFID II product governance / Retail investors, professional investors and ECPs target market** – Solely for the purposes of [the/each] manufacturer’s product approval process, the target market assessment in respect of the [Notes] has led to the conclusion that: (i) the target market for the [Notes] is eligible counterparties, professional clients and retail clients each as defined in [Directive 2014/65/EU (as amended, “MiFID II”)] [MiFID II]; **EITHER**²³ [and (ii) all channels for distribution of the [Notes] are appropriate[, including investment advice, portfolio management, non-advised sales and pure execution services]²⁴] **OR**²⁵ [(ii) all channels for distribution to eligible

¹⁸ Do not include this legend if the prospectus/offering circular relates to an issue of bonds that clearly falls outside the scope of the PRIIPs Regulation.

¹⁹ Do not include the reference to “No PRIIPs KID” in relation to issues of bonds that clearly fall outside the scope of the PRIIPs Regulation.

²⁰ Do not include the final sentence for issues of bonds that clearly fall outside the scope of the PRIIPs Regulation.

²¹ Do not include the reference to “No PRIIPs KID” in relation to issues of bonds that clearly fall outside the scope of the PRIIPs Regulation.

²² This drafting relates to ‘standalone’ bond issuance. Consideration will need to be given to adapting this language for a debt issuance programme and related drawdowns.

²³ Include for bonds that are not ESMA complex.

²⁴ This list may not be necessary, especially for bonds that are not ESMA complex where all channels of distribution may be appropriate. It reflects the list used in the examples in the ESMA Guidelines.

²⁵ Include for certain ESMA complex bonds.

counterparties and professional clients are appropriate; and (iii) the following channels for distribution of the [Notes] to retail clients are appropriate – investment advice, portfolio management, non-advised sales and pure execution services – subject to the distributor’s suitability and appropriateness obligations under MiFID II, as applicable]. Any person subsequently offering, selling or recommending the [Notes] (a “distributor”) should take into consideration the manufacturer[’s/s’] target market assessment; however, a distributor subject to MiFID II is responsible for undertaking its own target market assessment in respect of the [Notes] (by either adopting or refining the manufacturer[’s/s’] target market assessment) and determining appropriate distribution channels[, subject to the distributor’s suitability and appropriateness obligations under MiFID II, as applicable].²⁶

Short-form – For new issue announcements

- **MiFID II retail investors, professional investors and ECPs target market** – Manufacturer target market (MiFID II product governance) is eligible counterparties and professional clients (all distribution channels) and also retail clients ([all / suitability- or appropriateness-based]²⁷ distribution channels).

Very short-form – If needed by any third party market/trading screens

- MiFID II retail investors [(subject to suitability/appropriateness)]²⁸, professional investors and ECPs target market.

²⁶ Include for certain ESMA complex bonds.

²⁷ Include the latter option for certain ESMA complex bonds.

²⁸ Include for certain ESMA complex bonds.