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WHITE PAPER

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“To Be or Not to Be”: Determining When a European Bond is a PRIIP

On October 24, 2019, the European Supervisory Authorities (“ESAs”), consisting of the European Securities and Markets Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority, issued a joint statement on the circumstances under which the Packaged Retail and Insurance-based Investment Products (“PRIIPs”) Regulation applies to bonds.

A few days earlier, on October 16, 2019, the ESAs published a new Consultation Paper on Regulatory Technical Standards for PRIIPs and are now accepting comments until January 13, 2020.

In parallel, the European Commission will undertake a full-scale review of the PRIIPs Regulation, and the outcome of the review is expected to be published by December 31, 2019, after being pushed back a year.

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THE ESAs' JOINT STATEMENT

The ESAs' view has been that uncertainty over the application of Regulation (EU) No 1286/2014, known as the PRIIPs Regulation, to bonds has led to negative consequences for the functioning of bond markets—and for retail investors' willingness to access these markets. Therefore, the Joint Statement aims at achieving a consistent application of the scope of the PRIIPs Regulation, harmonizing the level of regulation and national supervision, and promoting a level playing field and the protection of retail investors. In essence, they qualify certain types of "simple" features in bond offerings that would not require a Key Information Document ("KID") for PRIIPs.

In the European Union, the practice has relied on the ESAs' Q&A on the KID¹ pursuant to which, *inter alia*, a "manufacturer is not required to draw up a KID for a product listed on a regulated market when they have defined the product as meant only for non-retail investors" ("General Topics," questions 1 and 2) in order to avoid the requirement to prepare a KID in connection with the issuance of corporate bonds, regardless of their features, provided that such bonds are not made available to retail investors.

In the recent past, most of the securities legends of international offerings into Europe and also cross-European offerings have therefore excluded retail investors from bond offerings in general, even where, under the Joint Statement, such bond offerings would not require a KID. From now on, in practice, it should also be possible to offer such bonds to a limited number of retail investors in each European country if offerors can

still rely on the exemption from the Prospectus Regulation² (i.e., less than 150 offerees) without the need of preparing a KID.

In order to promote a consistent application of the scope of the PRIIPs Regulation to the bond markets, the ESAs recommend that the EU Member State-level National Competent Authorities ("NCAs") apply the guidance set out in the Annex to their Joint Statement when supervising compliance with the requirements in Chapter I of the PRIIPs Regulation.

To date, no NCA has published a formal statement to endorse the ESAs' Joint Statement. Such NCA statement would be helpful in providing further certainty to the market.

Ultimately, the ESAs recommend that during the Upcoming Review of the PRIIPs Regulation, the co-legislators introduce amendments to the Regulation in order to specify more precisely which financial instruments fall within the scope of the Regulation. Doing so would fully address the risk of divergent applications by NCAs.

ESAs' CLASSIFICATION OF DIFFERENT FEATURES OF BONDS AND APPLICATION OF THE PRIIPs REGULATION³

The table below shows the ESAs' guidance on the application of the PRIIPs Regulation, in particular recitals 6 and 7 and Article 4(1), to different types of common bond features. Each type of bond or bond feature is considered individually. Where a bond combines various features, each feature needs to be considered separately.

Type of feature	PRIIPs with KID obligation?	ESAs' Main Considerations (verbatim from ESAs' Joint Statement)
Perpetual	No	<p>There are not considered to be any fluctuations in the amount repayable due to the fact that a bond is perpetual.</p> <p>Without prejudice to other features of a specific bond that could lead to review this assessment, this should lead to the conclusion that the "perpetual" feature of a bond <i>per se</i> does not imply that this bond falls in the scope of the PRIIPs Regulation.</p>
Subordinated	No	<p>There are not considered to be any fluctuations in the amount repayable due to the fact that a bond is subordinated.</p> <p>Without prejudice to other features of a specific bond that could lead to review this assessment, this should lead to the conclusion that the "subordinated" feature of a bond <i>per se</i> does not imply that this bond falls in the scope of the PRIIPs Regulation.</p>
Fixed rate	No	<p>There are not considered to be any fluctuations in the amount repayable. This would include:</p> <ul style="list-style-type: none"> - bonds with coupon payments fixed at a defined interest rate until maturity, including at zero; - bonds with pre-defined changes in the coupon rate at fixed times prior to maturity. <p>Without prejudice to other features of a specific bond that could lead to review this assessment, this should lead to the conclusion that the "fixed rate" feature of a bond <i>per se</i> does not imply that this bond falls in the scope of the PRIIPs Regulation.</p>
Variable rate	Not always	<p>The amount repayable is considered to be subject to fluctuations based on changes in the coupon rate. It is relevant to consider the basis for those fluctuations and whether there is any structuring. Pre-defined increases in the coupon rate (i.e. coupon step-ups) which are not linked to a reference value or to the performance of one or more assets which are not directly purchased are not considered to result in a bond being a PRIIP. This is considered to include changes due to a ratings downgrade of the issuer, change of control event, or tax or regulatory event.</p> <p>Where there is a direct link (with or without a spread that reflects the credit risk of the issuer) to an interest rate index, it is still considered to be an asset that is directly held unless there is additional structuring, such as a cap or floor (other than at zero); c.f. definition of a structured deposit. This direct link to an interest rate index would therefore not imply that the instrument is a PRIIP.</p> <p>Therefore, not all variable rate bonds are considered to be in scope, but it is dependent on the specific "variable" rate feature, as well as the other contractual features of the bond.</p>
Puttable	No	<p>Provisions that allow the investor to sell the bond back to the issuer are considered to be a contractual right to exit the investment and not to result in a bond being a PRIIP.</p> <p>Without prejudice to other features of a specific bond that could lead to review this assessment, this should lead to the conclusion that the "puttable" feature of a bond <i>per se</i> does not imply that this bond falls in the scope of the PRIIPs Regulation.</p>

Type of feature	PRIIPs with KID obligation?	ESAs' Main Considerations (verbatim from ESAs' Joint Statement)
Callable	Not always	<p>It is considered that provisions that allow the issuer of the bond to redeem the bond before maturity constitute a contractual termination of the investment and therefore do not inherently result in a fluctuation based on an exposure to a reference value.</p> <p>However, such features may result in that bond being a PRIIP, where the amount repayable at redemption is not fixed and fluctuation is caused by exposure to a reference value.</p> <p>The inclusion of a clause that allows the issuer to pay off the remaining debt early using a reference rate to determine the net present value of future coupon payments that will not be paid (i.e. make whole) is expected to mean that the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values. However, where the mechanism to calculate the discount rate is known in advance to the retail investor, this could be considered as a separate case, which does not satisfy the criteria in Article 4(1).</p> <p>Therefore, not all callable bonds are considered to be in scope, but some are expected to be on the basis of the specific "callable" feature, as well as depending on the other contractual features of the bond.</p>
Convertible	Yes	<p>Where the investor or issuer may convert the bond into shares of the bond issuer (or shares of another company) the amount repayable is considered to fluctuate based on the performance of an asset that is not directly purchased.</p> <p>Convertible bonds would therefore be considered to fall in the scope of the PRIIPs Regulation.</p>

PRACTICAL IMPLICATIONS OF THE JOINT STATEMENTS—A COMPARATIVE LAW VIEW

In this section, we examine the practical implications of the Joint Statement on international and cross-European bond offerings in several EU Member States (Germany, Belgium, France, the Netherlands, United Kingdom, Italy, and Spain).

Germany

A few weeks prior to the ESAs' publication of the Joint Statement, the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* or "BaFin") issued a similar paper on the supervisory treatment of individual features of corporate bonds under the PRIIPs Regulation.⁴ Similar to the ESAs, BaFin also stated that the individual features of a corporate bond must be considered on a case-by-case basis in order to assess whether or not the bond must be treated as a PRIIP.

BaFin so far has not issued a formal endorsement of the Joint Statement. As BaFin's classification of the same bond features (perpetual, subordinated, fixed rate, variable rate, puttable/callable, and convertible) led to the same results as the ESAs' assessment, we expect that BaFin will apply the considerations under the ESAs' Joint Statement for the German market even without a separate explicit endorsement of the ESAs' Joint Statement.

Belgium

The Belgian NCA, the Financial Services and Markets Authority ("FSMA"), has not publicly endorsed the ESAs' Joint Statement yet. However, it is expected that the FSMA will integrate the ESAs' guidance in its review and approval of prospectuses on bonds where some uncertainties remain about the application of the PRIIPs Regulations. Accordingly, the Joint Statement is likely to support the historically strong retail bond market in Belgium.

France

While the French NCA, the Financial Markets Authority (*Autorité des marchés financiers*), has not publicly endorsed the ESAs' publication of the Joint Statement, it is likely that the current corporate bond practice, which has so far relied on the ESAs' Q&A, will not be impacted by the Joint Statement.

The Netherlands

The Dutch NCA, the Authority for the Financial Markets (*Autoriteit Financiële Markten* or "AFM"), has not (yet) publicly endorsed the ESAs' Joint Statement. However, the AFM is likely to integrate the ESAs' guidance in its supervision in the same way as, for example, the ESAs' Q&A.

United Kingdom

The UK NCA, the Financial Conduct Authority ("FCA"), has not yet publicly endorsed the ESAs' Joint Statement. While normally the FCA would integrate the ESAs' guidance, given the United Kingdom's proposed withdrawal from the European Union, the position is uncertain.

Italy

The Italian NCA, the Italian Companies and Exchange Commission (*Commissione Nazionale per le Società e la Borsa*) has not yet adopted a specific communication on this topic. However, considering that Italy is a country of retail clients that invest in bonds, the ESAs' Joint Statement is positive news in the market.

Spain

In Spain, the CNMV (*Comisión Nacional del Mercado de Valores*) has not yet expressly endorsed the ESAs' Joint Statement, although its considerations will likely be applied by the CNMV. Thus far, the CNMV and the practice have relied on the ESAs' Q&A on the PRIIPs KID in order to avoid the preparation of a KID in connection with the issuance of corporate bonds that are not made available to retail investors. It remains unclear whether this practice will change in light of the Joint Statement.

KEY TAKEAWAYS

The ESAs' Joint Statement on the application of scope of the PRIIPs Regulation to bonds provides important guidance. However, it is only one among several steps of European-level amendment efforts to address issues that have come up in the past and to ensure consistent application of the scope of the PRIIPs Regulation, harmonizing the level of regulation and national supervision, and promoting a level playing field and the protection of retail investors.

To date, no NCA has published a formal statement to endorse the ESAs' Joint Statement. Such NCA statement would be helpful in providing further certainty to the market, but we expect that the new rules will make retail offerings easier and will soon be adopted by the local markets.

We will closely follow the legal discussions during the upcoming review of the PRIIPs Regulation and will keep you updated of any outcome.

Read the ["Joint ESA Supervisory Statement—Application of Scope of the PRIIPs Regulation to Bonds."](#)

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ENDNOTES

- 1 ESAs, Questions and answers (Q&A) on the PRIIPs Key Information Document, JC 2017 49, General topics, last updated April 4, 2019.
- 2 Regulation (EU) 2017/1129 of the European Parliament and of the Council of June 14, 2017, on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC Text with EEA relevance (“Prospectus Regulation”).
- 3 See “Annex to the Joint ESA Supervisory Statement—Application of Scope of the PRIIPs Regulation to Bonds.”
- 4 BaFin Guidance Notice, Supervisory treatment of individual features of corporate bonds under the PRIIPs Regulation (*Merkblatt Aufsichtsrechtliche Einordnung einzelner Ausstattungsmerkmale von Unternehmensanleihen auf Grundlage der PRIIPs-VO*), September 17, 2019.

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