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Client Alert

News Flash

Latham & Watkins Financial Regulatory and Capital Markets Practices

31 October 2019 | Number 2557

PRIIPs and Corporate Bonds — Clarity at Last?

ESAs issue important guidance in relation to the application of the PRIIPs Regulation to corporate bonds.

Key Points:

- The ESAs have issued their final view on whether certain features within bonds are conclusive as to the existence of a PRIIP.
- Importantly, it is now clear that the view of European supervisors is that the existence of a make whole, in isolation, should not lead to a conclusion that a corporate bond is a PRIIP.

On 24 October 2019, the European Supervisory Authorities (ESAs), consisting of ESMA, the EBA, and EIOPA, published a statement on the application of scope of the PRIIPs Regulation to bonds. The statement confirmed that, in the absence of any other indicators leading to a conclusion that the bond should be treated as a PRIIP, the following features should not trigger a conclusion that a bond is a PRIIP:

Type of feature	ESAs' position
Perpetual	The "perpetual" feature of a bond *per se* does not imply that this bond falls within scope of the PRIIPs Regulation.
Subordinated	The "subordinated" feature of a bond *per se* does not imply that this bond falls within scope of the PRIIPs Regulation.
Fixed rate	The "fixed rate" feature of a bond *per se* does not imply that this bond falls within scope of the PRIIPs Regulation. This would include: • 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

Type of feature	ESAs’ position
Variable rate	Not all variable rate bonds are considered to be in scope, but it is dependent on the specific “variable” rate feature, as well as on the other contractual features of the bond. 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) that 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. If there is a direct link (with or without a spread that reflects the issuer’s credit risk) 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. **Note**: The ESAs have not confirmed that an inflation linked bond providing a floating rate of return calculated in a linear fashion is not a PRIIP. Arguably, this should also be excluded from scope because the inflation-linkage in this case is a way of adjusting the nominal interest rate, to turn the rate into a real one, and does not affect the basic nature of the bond, which is still a directly held asset. Nevertheless, firms will need to continue to lobby for more clarity in this context.
Puttable	The “puttable” feature of a bond *per se* does not imply that this bond falls within scope of the PRIIPs Regulation. Rather, it is a provision that allows the investor to sell the bonds back to the issuer, and so is a contractual right to exit.
Callable	Not all callable bonds are considered to be in scope, but some are expected to be in scope on the basis of the specific callable feature, as well as depending on the other contractual features of the bond. 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. However, such features may result in that bond being a PRIIP, if the amount repayable at redemption is not fixed, and fluctuation is caused by exposure to a reference value. **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.**

Type of feature	ESAs’ position
	However, if 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).
Convertible	If 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. Convertible bonds would therefore be considered to fall within scope of the PRIIPs Regulation.

What is the impact of the ESAs’ statement?

In order to promote a consistent application of the scope of the PRIIPs Regulation to bond markets, the ESAs recommend that EU Member State-level national competent authorities apply the guidance set out in the Annex to the Statement when supervising compliance with the requirements in the PRIIPs Regulation.

Ultimately, it is hoped that the upcoming review of the PRIIPs Regulation will introduce amendments to specify more precisely which financial instruments fall within scope of the Regulation — specifically addressing the stated intention of the PRIIPs Regulation to capture packaged or wrapped products, rather than assets that are held directly. However, there is no indication at this stage that such clarity will come in the form of revision to the Level 1 text, and therefore the statement from the ESAs is the most robust guidance available for the time being.

The market will monitor closely whether each Member State national competent authority will publish a statement to formally endorse the ESAs’ guidance. This would be welcomed as providing further certainty to the market.

Status of the “make whole” in a PRIIPs determination

Make whole clauses allow an issuer to manage its liabilities, while simultaneously protecting the investor from financial disadvantage. The issuer can repay the bonds only by paying a make whole premium, in addition to the redemption amount of par, to compensate bondholders for the loss of future interest payments. The calculation of the premium to the investor is based on a customary formula to determine the current market value of the bond using a standardised underlying reference value — *e.g.*, Treasury bonds. The clause is designed to ensure that investors receive back at least the market value of the bond at the time of early redemption, and in no case less than par. This gives investors an opportunity to reinvest in an equal or (usually) better credit at the same yield.

There has long been uncertainty as to whether the inclusion of a make whole in a corporate bond should trigger a PRIIPs determination. Due to the very broad definition of a PRIIP (see box below) and the fact that a make whole is calculated by reference to an underlying reference value, it has not been possible to advise firms that the legislators’ intention was to exclude corporate bonds that include a make whole from scope.

The normal course return of a bond may be fixed and known to the investor at the outset. Such a bond would not make reference to any underlying assets or reference values in calculating that return in the way envisaged by the investment objectives of an in-scope PRIIP. However, such an instrument may nevertheless, as part of its general terms and conditions, contain a make whole provision that provides a mechanism for calculating the return to the investor in the case of bonds terminating before maturity at the election of the issuer (rather than as part of the intended lifecycle of the bond).

A PRIIP is an investment where, regardless of its legal form, 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.

To phrase this point another way, if there is no relationship between an instrument's return and that of an underlying investment asset or reference value, other than in the case of an early termination event, such instrument should not meet the definition of a PRIIP.

Notwithstanding the lack of legal certainty to date, an important distinction must be drawn between an instrument's investment objectives and terms that govern the amount due to an investor when the issuer exercises a redemption right. For example, Article 2(1) of the Delegated Regulation confirms that the investment objectives of a PRIIP shall identify the main factors on which the return depends, the underlying investment assets or reference values, and how the return is likely to be determined — as well as the relationship between the PRIIP's return and that of the underlying investment asset or reference values. In line with the drafting of the Delegated Regulation, the PRIIP's investment objective can be distinguished from the disinvestment procedure, which is set out in a separate provision of the Delegated Regulation.

In summary, there are now strong technical arguments that a corporate bond possessing a make whole should not be in scope of the PRIIPs Regulation. The recent statement from the ESAs can be seen as a sign that the EU regulators agree with those arguments.

Key considerations for syndicate banks

- **Liability**: Obligations under the PRIIPs Regulation attach to manufacturers of PRIIPs (in the case of corporate bonds, the issuer) and those distributors selling directly to retail investors. For the reasons set out above, the chance of any European regulator determining that a corporate bond, by virtue of the inclusion of a make whole, should be considered a PRIIP, are now unexpected. Nevertheless, for banks that do not sell directly to retail investors, any liability in this regard is limited due to the scope of the PRIIPs Regulation.

- **Offering documents**: References to KID availability in offering documents should be considered and removed, as appropriate, to avoid any inference that the bond is a PRIIP. Further, make whole provisions should be reviewed to ensure that the mechanism to calculate the discount rate is known in advance to the retail investor. In this regard, it may be necessary to consider whether the method of disclosure is comprehensible to the average retail investor.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

M. Ryan Benedict
ryan.benedict@lw.com
+39.02.3046.2035
Milan

Lene Malthasen
lene.malthasen@lw.com
+44.20.7710.1186
London

James Baxter
james.baxter@lw.com
+44.20.7710.1030
London

Carl Fernandes
carl.fernandes@lw.com
+44.20.7710.4777
London

Rob Moulton
rob.moulton@lw.com
+44.20.7710.4523
London

Anne Mainwaring
anne.mainwaring@lw.com
+44.20.7710.1018
London

Nicola Higgs
nicola.higgs@lw.com
+44.20.7710.1154
London

Basil Al-Jafari
basil.al-jafari@lw.com
+971.4.704.6403
Dubai

Charlotte Collins
charlotte.collins@lw.com
+44.20.7710.1804
London

Jeffrey H. Lawlis
jeff.lawlis@lw.com
+39.02.3046.2000
Milan

Edward R. Kempson
edward.kempson@lw.com
+7.495.644.1928
Russia

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